WINDFALL PROFITS TAX COLLECTIONS AND INDEPENDENT GASOLINE MARKETERS

HEARING

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND THE ECONOMY

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

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WINDFALL PROFITS TAX COLLECTIONS AND INDEPENDENT GASOLINE MARKETERS

THURSDAY, SEPTEMBER 15, 1983

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND THE ECONOMY,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:36 a.m., in room 2359-A, Rayburn House Office Building, Hon. Berkley Bedell (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN BEDELL

Mr. BEDELL. The subcommittee will come to order.

This morning, the Small Business Oversight Subcommittee meets to explore the Treasury Department's proposed remedy for alleged tax underpayments by the major Alaska North Slope crude oil producers.

As everyone here this morning is aware, the methodology used by certain ANS producers to determine the value of ANS crude oil has been a topic of much discussion among the gasoline marketing community.

Last December, the Small Business Committee heard testimony from independent gasoline marketers that the major ANS producers were using different methods of determining the value of their ANS crude oil.

In particular, these marketers complained that one integrated company, Arco, was underestimating the wellhead value of their ANS crude, and underpaid the windfall profits tax on this oil by an amount large enough to significantly lower their retail gasoline prices, and gain a substantial competitive advantage over other marketers.

The three major ANS producers are Arco, Exxon, and Sohio. All three companies will testify later this morning.

Since our December hearing, I have written to the Treasury Department on two separate occasions to urge them to investigate these allegations. I am also aware of efforts to encourage the Treasury Department to review this matter by other Members of Congress, including our ranking member, Silvio Conte, and our first witness this morning, Bill Nelson of Florida.

On August 22, exactly 8 months since my first communication with the Treasury Department, the IRS issued Revenue ruling 83-124. This ruling seeks to clarify the proper method to figure the re-

moval price of a barrel of ANS crude oil for the windfall profits tax.

Because any proposal to restructure these removal price calculations can have a tremendous impact on the competitive factors in downstream gasoline markets, Revenue ruling 83–124 was met with great anticipation by all members of the gasoline marketing community. Unfortunately, this anticipation has given way to considerable confusion over the significance, substance, and intent of the ruling.

It is my hope that this hearing will offer all parties directly and indirectly affected by Revenue ruling 83–124 an opportunity to express their views. I intend, as chairman of this subcommittee, to present these views to the Treasury Department.

On that matter, I wish to take a moment to explain the arrangement that the subcommittee has with the Treasury Department for this hearing.

The Treasury Department initially refused the subcommittee's invitation to appear as a witness at our hearing. However, the primary purpose for this meeting is to solicit the Treasury Department's response to the points raised by our witnesses about their Revenue ruling. Naturally, it is unacceptable for an administrative agency to refuse to meet with members of this subcommittee on a matter of this significance.

As a result, the Treasury Department will have a representative present to listen to the testimony and question and answer sessions with our witnesses.

Then, immediately following the testimony of our last witness, the subcommittee will adjourn to the small hearing room next door to meet privately with John Chapoton, the Assistant Secretary for Tax Policy at the Treasury Department. After that meeting, I will be available to meet with the press and other interested parties in this room.

Mr. Sisisky, do you have any statements that you would like to make?

Mr. SISISKY. Nothing now.

Mr. BEDELL. Mr. Bilirakis, do you have any?

Mr. BILIRAKIS. Yes, sir, I do.

OPENING STATEMENT OF HON. MICHAEL BILIRAKIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. BILIRAKIS. I would like to commend you, Mr. Chairman, for your continuing commitment to competition in the gasoline marketplace, and your concern over alleged tax underpayments.

I look forward to the testimony that will be presented to us today, and I commend the witnesses for their willingness to appear.

Needless to say, when we are looking at a deficit in the neighborhood of $200 billion, it is important that the Congress and the administration carefully scrutinize the tax laws and practices to insure that the letter of the law is being followed, and that the Treasury is getting every dollar that is due.

Obviously, I am concerned as I know other members of the subcommittee are, when we read that the GAO has estimated that the Federal Government may be losing $500 million to $800 million an-

nually in revenue because of the methods of computation for windfall profits taxes used by various oil companies producing in the Alaska North Slope.

I believe strongly in the free enterprise system, as you know, Mr. Chairman, and in the spirit of competition.

It is important, however, for the Congress and the Treasury Department to know if the calculations used to determine windfall profits by crude oil producers in Alaska's North Slope are, in fact, depriving the U.S. Treasury of much needed revenues, and whether certain companies are achieving—and this is of utmost importance to us in this committee—an unfair advantage over their competitors because of their methods of calculation.

It goes without saying that, if this is the case, every car owner in this Nation, would be impacted at the pumps ultimately, not to mention every American who must pay the price of our deficit.

I would hope that the Department of the Treasury will give careful attention to the points brought up during the course of this hearing so that members of this subcommittee and Treasury officials may have meaningful dialog on the proposed Treasury remedy for tax underpayments.

It is vital that we preserve competition and insure that every company plays by the same rules, without clever manipulation of congressional intent.

As a graduate petroleum engineer, Mr. Chairman, I can understand the problems of the oil companies. As a taxpayer, and as a Member of this Congress which is struggling to balance the budget, I am determined, as you are, that every corporation bear its fair share of the burden, and I am particularly concerned with any adverse impact on the small businessman.

Consequently, I am anxiously awaiting the testimony we will be hearing today.

Thank you, Mr. Chairman.

Mr. BEDELL. Thank you very much, Mr. Bilirakis.

Mr. Ray, do you have any questions?

Mr. RAY. No questions.

Mr. BEDELL. We have a statement by Mr. Mavroules that, without objection, will be made a part of the record.

[Mr. Mavroules' opening statement with attachments follows:]

OPENING STATEMENT OF HON. NICHOLAS MAVROULES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. Chairman, I appreciate this opportunity to appear this morning before your subcommittee on behalf of the small gasoline operators in my district.

Since last December's hearings on gasoline marketing, members of the Small Business Committee have been aware of the charges that the Atlantic Richfield Company (ARCO) may be improperly avoiding payment of hundreds of millions of dollars in windfall profit taxes.

In the past few weeks, my office has been inundated with letters and calls from independent marketers throughout the Commonwealth of Massachusetts. Many of these gasoline operators have been able to survive the oil embargos, low margins and all the other problems inherent with operating a small business. Yet ARCO's unfair economic advantages and anti-competitive practices are now threatening the livelihood of these small businessmen.

I would like to submit for the Record a letter I recently received from Mr. Richard Salinsky, President of Best Petroleum, a medium independent jobber from Lynn, Massachusetts. Mr. Salinsky's letter, I believe, pointedly and succinctly describes the problems now facing all the independent marketers in the state.

I would also like to submit for the record a copy of some figures Mr. Salinsky sent me, that were compiled from the "Massachusetts Distributors Taxable Gallonage Report" issued monthly by the Massachusetts Petroleum Counsel. Let me just say that I agree with the analysis that these figures can only lead us to the inescapable conclusion that since 1981 ARCO has drastically increased its market share at the expense of the independent marketers, while during that same period the volume for the entire state remained constant.

The actions by ARCO, outlined in Mr. Salinsky's letter and upheld by these figures, could endanger the continuing viability of Mr. Salinsky's company and others in the Commonwealth, and ultimately place the consumer's interest for quality products at competitive prices in severe jeopardy.

I respectfully urge your subcommittee, Mr. Chairman, to heed the pleas for help from Mr. Salinsky and other small gasoline operators.

BEST PETROLEUM CO., INC.,
Lynn, Mass., July 20, 1983.

Hon. NICHOLAS MAVROULES,
House of Representatives,
Longworth House Office Building, Washington, D.C.

DEAR MR. MAVROULES: As a small businessman and one of the taxpayers you represent, I want to call your attention to the nearly $200 million in taxes the U.S. Treasury may have lost last year to one oil company.

I seek your support in resolving this tax shortfall and in preventing an even greater shortfall if other oil companies were to garner similar tax savings.

Specifically, the problem seems to be a significant inequity in the Internal Revenue Code relating to Windfall Profit Taxes on Alaska North Slope crude oil. The Atlantic Richfield Company (ARCO) interprets certain provisions of the Windfall Profit Tax in a way that allows substantial and unintended benefits. Those benefits, in turn, have been employed in an anticompetitive manner to the detriment of many of my fellow independent marketers and ARCO's refining competitors.

By using this special tax benefit, ARCO has already inflicted a substantial and irrevocable injury on the independent segment of the motor fuel marketing industry . . . and at the same time eased their own tax burden while increasing the share others must bear.

I'm enclosing a detailed explanation about the questionable legal interpretation ARCO uses in computing tax liability. With this method, ARCO realizes a tax savings of approximately $2 per barrel for each of the more than 270,000 barrels of crude oil it produces each day on the North Slope of Alaska.

The other two largest producers of North Slope crude, Exxon Corporation and Standard Oil of Ohio, compute their tax in a wholly different manner . . . at least right now. Their method results in a greater tax liability. Were these companies to use ARCO's method, the U.S. Treasury would see even greater shortfalls from expected taxes.

Perhaps just as important as the means ARCO uses are the results of the misuse. These tax savings have allowed ARCO an inequitable competitive advantage in the retail and wholesale markets for motor fuels, allowing the company to increase its share of the market to the expense of its independent competitors. In a way, the U.S. Treasury is effectively subsidizing ARCO's infliction of substantial injury on the structure of competition in the retail market for motor fuels.

Prompt action to repair this damage is essential.

I realize that finding a legislative solution could be difficult. However, the Department of the Treasury could resolve this matter administratively.

I respectfully request that you urge the Treasury to act promptly to resolve this matter by a ruling or through rulemaking.

I appreciate your concern and look forward to receiving your response as soon as possible.

Sincerely,

RICHARD P. SALINSKY, *President.*

BEST PETROLEUM CO., INC.,
Lynn, Mass., September 12, 1983.

Congressman NICHOLAS MAVROULES,
Longworth House Office Building,
Washington, D.C.

DEAR CONGRESSMAN MAVROULES: As you requested, I have compiled figures from the "Massachusetts Distributors Taxable Gallonage Report" issued monthly by the

Massachusetts Petroleum Counsel. The attached sheets represent the gasoline sales of each company. Even though some companies may have added or lost customers or locations during this period, the numbers do lead one to the inescapable conclusion that since 1981 ARCO has drastically increased its market share at the expense of the independent marketers, while during the same period the volume in the State has remained constant. The following is a summary of my findings.

[In percent]

	1982 versus 1981	(6 months) 1983 versus 1981
1. Commonwealth of Massachusetts	99.40	100.70
2. Arco	157.86	173.86
3. Mobil	96.25	96.69
4. Exxon	94.18	92.02
5. Very large independent refiner	83.12	78.74
6. Large independent jobber	78.76	70.86
7. Medium independent jobber	90.78	81.35
8. Small independent jobber	50.09	41.37
9. Small independent jobber	82.50	67.47

As a result of Arco's apparent miscalculations of the Windfall Profits Tax, not only is the Treasury being denied hundreds of millions of dollars in revenue, but this unfair subsidy of Arco's retail locations is denying the independents their historical share of the Massachusetts market, while their margins have decreased to a dangerously low level.

COMMONWEALTH OF MASSACHUSETTS—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

	1981	1982	1983
January	186,597,615	180,981,551	175,159,183
February	163,816,896	159,025,813	160,282,004
March	185,094,587	179,569,921	193,996,579
April	167,452,109	178,671,357	179,430,607
May	184,645,396	186,790,700	189,970,798
June	191,344,687	186,952,168	187,613,169
Total for 6 months	1,078,951,290		1,086,452,340
July	195,531,776	194,265,228	
August	193,131,128	192,677,000	
September	184,700,667	185,776,713	
October	195,225,900	186,742,468	
November	175,514,825	179,312,851	
December	194,450,295	193,324,919	
Total	2,217,505,881	2,204,090,689	

ARCO—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

	1981	1982	1983
January	10,444,099	12,154,033	17,347,452
February	8,157,858	11,963,190	16,685,180
March	9,209,151	13,311,672	17,859,940
April	11,292,283	13,286,562	18,443,669
May	10,561,724	18,527,814	17,369,382
June	10,875,936	19,674,400	17,549,286
Total for 6 months	60,541,051		105,254,909

ARCO—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983—Continued

	1981	1982	1983
July	11,558,943	19,832,570	
August	11,726,823	20,126,694	
September	11,600,739	20,365,925	
October	12,249,775	20,818,998	
November	12,007,193	19,618,847	
December	13,291,808	20,231,666	
Total	132,976,332	209,912,371	

MOBIL—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

	1981	1982	1983
January	25,111,902	20,646,236	19,333,098
February	17,969,876	18,445,803	18,594,064
March	22,799,275	20,679,850	22,595,566
April	21,705,250	21,095,282	21,005,663
May	22,371,383	22,385,377	22,897,401
June	22,633,024	23,241,023	23,778,626
Total for 6 months	132,590,710		128,204,418
July	24,044,551	23,429,496	
August	24,235,101	23,207,678	
September	22,609,951	20,936,143	
October	22,272,692	21,325,108	
November	20,323,377	21,303,297	
December	22,636,592	21,938,539	
Total	268,712,974	258,624,832	

EXXON—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

	1981	1982	1983
January	12,610,559	10,096,711	9,543,259
February	10,467,689	9,037,871	8,973,021
March	11,195,659	9,545,984	10,276,945
April	10,464,084	9,698,633	10,107,675
May	10,890,458	10,368,252	10,906,617
June	10,962,691	10,871,072	11,472,373
Total for 6 months	66,591,140		61,279,890
July	10,698,107	10,828,911	
August	11,852,464	10,964,824	
September	10,824,511	10,748,369	
October	11,432,701	11,090,122	
November	10,123,000	10,397,724	
December	11,027,885	11,186,735	
Total	132,549,808	124,835,208	

AMERADA HESS CORP.—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

[Very large independent refiner]

	1981	1982	1983
January	5,506,696	5,677,223	5,024,535
February	4,771,087	4,481,386	4,548,847
March	6,220,607	5,217,925	4,917,628
April	6,379,447	5,780,889	5,129,928
May	7,307,503	6,030,435	4,795,393
June	7,077,971	5,658,382	4,924,895
Total for 6 months	37,263,311		29,341,226
July	7,198,894	5,958,759	
August	7,270,426	5,416,113	
September	6,635,547	5,509,951	
October	7,426,737	5,840,595	
November	6,804,969	5,144,649	
December	6,870,992	5,341,142	
Total	79,470,876	66,057,449	

J. R. SOUSA & SONS, INC.—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

[Large independent jobber]

	1981	1982	1983
January	5,617,798	5,490,636	4,037,494
February	5,837,550	4,968,706	3,875,271
March	5,977,743	5,643,802	4,641,723
April	6,261,819	5,394,721	4,068,905
May	6,215,770	5,587,554	4,627,511
June	6,473,804	5,307,274	4,530,997
Total for 6 months	36,384,484		25,781,901
July	7,451,911	5,662,791	
August	7,233,471	5,314,253	
September	6,599,701	4,412,192	
October	6,613,985	3,896,877	
November	5,927,359	3,694,174	
December	5,810,752	4,502,828	
Total	76,021,663	59,875,808	

BEST PETROLEUM CO., INC.—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

[Medium independent jobber]

	1981	1982	1983
January	2,299,828	2,420,648	2,121,515
February	2,165,460	2,233,166	1,846,592
March	2,471,063	2,634,540	2,265,345
April	2,370,159	2,365,814	1,651,628
May	2,555,361	2,147,515	2,031,665
June	2,454,383	1,916,718	1,952,318
July	2,593,886	2,101,179	1,886,949
Total for 7 months	16,910,140		13,756,012
August	2,495,290	2,141,893	
September	2,473,137	2,046,549	

BEST PETROLEUM CO., INC.—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983—Continued

[Medium independent jobber]

	1981	1982	1983
October	2,620,015	2,151,703	
November	2,061,958	2,079,767	
December	2,565,823	2,202,599	
Total	29,126,363	26,442,091	

QUINCY OIL CO.—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

[Small Independent jobber]

	1981	1982	1983
January	404,211	325,014	176,531
February	325,039	246,425	158,384
March	439,077	281,558	201,334
April	459,727	215,876	159,353
May	466,771	201,402	172,823
June	433,046	187,932	177,241
Total for 6 months	2,527,871		1,045,666
July	424,879	180,900	
August	406,106	173,166	
September	389,968	94,216	
October	378,900	166,743	
November	335,165	145,798	
December	343,938	188,660	
Total	4,806,827	2,407,690	

GINN OIL CO.—MASSACHUSETTS STATE TAXABLE GALLONAGE REPORT, JANUARY 1981–JULY 1983

[Small independent jobber]

	1981	1982	1983
January	359,345	321,814	175,499
February	240,312	284,095	216,443
March	395,206	242,632	238,667
April	290,935	256,037	165,933
May	318,920	214,205	196,061
June	207,286	235,465	229,936
Total for 6 months	1,812,004		1,222,539
July	244,505	179,414	
August	229,572	203,514	
September	244,333	203,968	
October	245,420	189,065	
November	268,192	191,861	
December	303,881	239,788	
Total	3,347,907	2,761,858	

Mr. BEDELL. I should state that Mr. Conte was most anxious to be here for these hearings. It is my understanding that he has a markup in Appropriations concerning legislation that he is involved with personally, and he will come over as soon as he can get that finished.

We are delighted that our first witness is Bill Nelson from Florida.

Bill has been very much involved in this issue. We appreciate greatly the interest you have taken and the involvement that you have shown in this issue, Bill. Upon the completion of your testimony, we would be delighted if you would join the committee here for as much of the hearing as you can participate in.

You may proceed.

Mr. NELSON. Thank you, Mr. Chairman.

TESTIMONY OF HON. BILL NELSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. NELSON. Mr. Chairman, members of the committee. I appreciate this opportunity to share some thoughts with you and then to join you on the panel for the rest of the hearing.

I got into this issue last December when I was serving as chairman of the task force on tax policy of the Budget Committee. In that capacity, I wrote to the General Accounting Office [GAO], requesting information on the windfall profits taxes paid on oil coming off the Alaskan North Slope.

In that letter I asked a number of questions, which the GAO has now addressed in an investigation, such questions as how the wellhead price is determined; how tariffs are charged for the Trans-Alaskan Pipeline; how the cost of waterborne transportation is determined; how much windfall profits tax has been paid on the Alaskan North Slope crude oil; how much Alaskan North Slope crude oil is exempt; and a question such as, is the Federal Government receiving all of the revenue due it from the collection of the windfall profits tax?

Well, during the next several months, the GAO touched bases with my office several times to clarify the questions that we had asked, and to inform me of the status of the investigation.

In July, we had a 3-hour briefing in my office by some of the professional staff of GAO. Because the final written report will be published this December—it takes them about 6 months to put it together—we will have a lot of the specific answers that will be forth coming when it comes out in December.

Consequently, the GAO has given me a lengthy oral briefing. That briefing was the subject of my press conference in early August, Mr. Chairman. That was also the subject of my comments to you, both in writing and personally. I appreciate the opportunity to be here, and I am thankful for you, along with Chairman Dingell and Chairman Rostenkowski, each of whom, under their respective jurisdictions, will be looking at this question.

Now, the conclusions of the GAO were most interesting. The GAO admitted that there definitely is a problem with collection of the windfall profits tax, specifically on the Alaskan North Slope.

GAO also revealed that they were given permission to investigate individual taxpayer files of the IRS, although the figures had to be aggregated before that they could be released to me. No individual taxpayer information is allowed to be released because of the Privacy Act, and, of course, that is as it should be.

However, according to the IRS, as reported to us by GAO, there is approximately $500 to $800 million revenue loss annually since the windfall profits tax legislation went into effect in March 1980.

Well, as you know, that was the whole purpose of my inquiry from the Budget Committee. I was astounded to hear that such revenue losses had resulted from a tax law that has been on the books for 3½ years. If the facts of this GAO investigation prove to be true, then we have a distinct interest and responsibility as Members of the U.S. Congress to get involved and to find out exactly why this is happening.

During the lengthy briefing in July, the GAO staff shared that the IRS would be coming out with a ruling on the determination of a wellhead price. That ruling is the subject of today's hearing.

On August 8, a few days after my news conference, the IRS did in fact, issue this ruling.

I have consulted with a number of experts since this ruling was announced, and I haven't found anyone who feels that this ruling changes the situation significantly. I would be very interested to hear the perspective of the IRS.

We don't have any regulations. This was a ruling. IRS has had a study group on this subject since June 1982. I think it is an open question for us to ask: Is this ruling a legitimate substitute for an IRS regulation on the subject?

Well, I think we are in a forum here that we can keep the spotlight on this issue, and come to a conclusion and, if we do, suggest strongly to the IRS that this issue ought to be dealt properly. Now, as a matter of overall budgetary policy, it is inconceivable that we could have a tax law on the books for 3½ years without the Federal Government collecting the revenues as intended by the Congress.

Now, remember there is a statute of limitations on tax law of 3 years. What that means is that the Federal Government can't go back and sue to get taxes that were due the Government if it is earlier than the period of 3 years.

Of course, since the windfall profits tax went into effect in March 1980, we have now passed a period of 6 months from about March until September 1980, that unless there is a private agreement between the companies involved and the IRS that we don't know about, that revenue that has not been collected under the windfall profits tax in that period is lost to the Treasury forever because of the statute of limitations.

Now, let me expand and clarify these statistics that I have used. If that figure which has been propounded to me by the GAO from the IRS of $500 to $800 million annually is in fact true, then we are talking in the range of about $7,700 loss in revenues a day. I think that it is imperative that we respond, and also the IRS respond.

Mr. Chairman, I wrote to you to inform you of those GAO findings as well as Chairman Dingell and Chairman Rostenkowski. I have both spoken to them personally and written to them on this subject. I wanted to pursue this and to offer assistance in my capacity on the Budget Committee to you three and the committees of jurisdiction that you chair.

[See app. B.]

Mr. NELSON. Now, take for example, Chairman Rostenkowski, there is a bill that is going to be marked up this month, H.R. 3475, that would allow the IRS to exchange taxpayer data with the State of Alaska. The State of Alaska income tax forms are very detailed, and we have indication that the State of Alaska is willing to share this information; but the IRS has to have the legal authority in order to exchange that information. It is my understanding that Chairman Rostenkowski will be taking up that issue this month in the markup of H.R. 3475, the Tax Law Simplification and Improvement Act.

The IRS is allowing these dollars due to the Federal Government to be lost, if it does nothing, or if it does it only through a weak ruling. If, in fact, the GAO confirms in writing the results of their verbal report to me, then those dollars are being lost every day.

These are dollars that could be used, needless to say, to reduce our bulging Federal deficit.

I have been careful in my news releases not to mention any specific oil companies that are involved; that is not my province. My province is macroeconomic policy. I will leave that to the specific committees to handle.

In the pumping of that oil from the Prudhoe Bay oilfield and the Kuparak River oilfield on Alaska's North Slope, the methods by which the oil companies have been determining the wellhead price is the net-back method. That is the term that they use, and basically what they do is that they take costs; for example, differences in market price, pipeline costs, and waterborne transportation, and they back those costs out from the sales price. Usually, that sales price is the price that is determined in west Texas sour crude oil.

They back out those expenses to get back to a wellhead price on which the windfall profit tax is paid. Well, the GAO evidence is that those transportation costs are being inflated, thereby reducing the wellhead price, and, consequently, the windfall profits tax that is paid. So as we pursue our investigation, we want to determine specifically how that is being done, and to what extent. The problem, as outlined to me by GAO, is that it is possible that a wrong base is being used and that in the netting back it is possible that some of those costs, as I mentioned, such as transportation, are being calculated incorrectly. If those costs, then, are inflated too much, and are too high, and the wellhead prices are too low, the tax paid to the Government would be too low.

I am looking forward to joining you today, Mr. Chairman, and members, in this hearing. I will be happy to try to answer any questions.

Mr. BEDELL. Thank you very much, Mr. Nelson.

[Congressman Nelson's prepared statement follows:]

PREPARED STATEMENT OF HON. BILL NELSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

I appreciate the opportunity to appear, and subsequently to join, this distinguished panel in the examination of the recent ruling issued by the Internal Revenue Service on the computation of the windfall profit tax on Alaska's North Slope. I also want to commend you, Mr. Chairman, for holding today's hearing on this timely subject.

Last December, as Chairman of the House Budget Committee's Task Force on Tax Policy, I sent a letter to the General Accounting Office (GAO) requesting informa-

tion on the windfall profit taxes paid on oil taken from the Alaskan North Slope. In my letter I asked a number of questions which the GAO has addressed in its investigation. There were a number of points that were included in their investigation such as: how the "wellhead price" is determined; how tariffs are charged for the Trans-Alaskan Pipeline (TAP); how the cost of waterborne transportation is determined; how much windfall profit tax has been paid on Alaskan North Slope crude oil; how much Alaskan North Slope crude oil is "exempt;" and is the federal government receiving all of the revenue due to it from the collection of windfall profit taxes on the Alaskan North Slope?

During the next several months, GAO touched bases with my office several times to clarify questions and to inform me of the status of the investigation. In July, my office received a three hour briefing by 6 or 7 of the professional staff of GAO on their findings. Because the final written report will take approximately six months to publish—after all the facts and figures are cited and cleared through all of the levels of their bureaucracy and other agencies involved—the GAO requested the opportunity to conduct this lengthy oral briefing the end of July.

The conclusions of the GAO that were related to me were most interesting. First of all, the GAO admitted that there definitely is a problem with collections of windfall profit taxes on the Alaskan North Slope.

Secondly, GAO was given permission to investigate individual taxpayer files of the IRS, although the figures had to be aggregated before they could be released to me. No individual taxpayer information is allowed to be released because of the Privacy Act—and that is as it should be. However, according to the IRS, there has been approximately a $500–$800 million revenue loss annually since the windfall profit tax legislation went into effect in March 1980.

As a member of the Budget Committee, I was astounded to learn that we have such revenue losses from a tax law that has been on the books for 3½ years during a time that we are facing astronomical deficits in the next several years. I was even more astounded to learn that the IRS has not even issued regulations for the correct procedure to determine the wellhead price, and consequently, the windfall profit tax owed to the federal government. At this briefing in July, the GAO staff also mentioned that the IRS would be coming out with a ruling on this subject in the next couple of weeks. On August 8, 1983—four days after my news conference announcing several of the GAO conclusions—the IRS ruling was announced. I have consulted with a number of experts in this field since the ruling was announced, and I have not found anyone who feels that this ruling changes the situation significantly. However, I will be anxious to hear the reactions of later witnesses to this ruling.

We still have no regulations—although IRS has had a study group on this subject since June 1982—and the ruling is a very weak substitute. The pressure must be kept on the IRS to make them aware of the necessity for issuing these regulations. It is inconceivable to me that we could have a tax law on the books for 3½ years—the statute of limitations for taxes is 3 years—without a hint of regulations in the offing. To give you an idea of how much we are talking about on a daily basis, the GAO has estimated that for each one cent difference in the wellhead price of a barrel of oil, there is a loss of $7,700 in revenues a day! It is imperative that the IRS respond to this situation immediately.

As you recall, I wrote to you to inform you of the GAO findings. In addition, because of their interest in the subject, I also informed Chairman John Dingell of the Energy and Commerce Committee and Chairman Dan Rostenkowski of the Ways and Means Committee of the GAO conclusions. In addition, I have requested that Chairman Rostenkowski include a provision in a bill due to be marked up this month—H.R. 3475, the Tax Law Simplification and Improvement Act of 1983—that would allow the IRS to exchange taxpayer data with the State of Alaska. Although I have not heard directly from Chairman Rostenkowski, it is my understanding from the staff that this is likely to be included in their markup of H.R. 3475. Hopefully, this additional information from the extensive Alaska tax forms would be helpful to the IRS as it assesses the possibility of future regulations.

The IRS is allowing these dollars due to the federal government to be lost each day that it puts off issuing regulations. These are dollars that could help to reduce the huge federal deficits that we have been wrestling with on the Budget Committee and in the Congress as a whole.

The oil companies that are pumping oil from the Prudhoe Bay oilfield and the Kuparak River oil field on Alaska's North Slope have been using "net-back" methods to determine the wellhead prices on which windfall profit taxes are based.

Generally, they have been using the market price of West Texas sour crude oil delivered to the Gulf of Mexico as the base. Then the transportation charges of the

pipeline and ship are deducted as well as other costs to determine the wellhead price on which the windfall profit tax is based.

The problem, as determined by the GAO, is that it is possible that an incorrect base is being used and that in the netting back some of the costs such as these transportation costs, are being calculated incorrectly. If these costs were too high, then the profits at the wellhead would be understated and so, of course, would the windfall profit tax.

I am looking forward to hearing the testimony from our witnesses today. I am curious to hear their reactions to the new IRS ruling and the affect that they expect it to have on their own calculations of their windfall profit tax.

Mr. BEDELL. Mr. Sisisky.

Mr. SISISKY. This is a very complicated subject.

Bill, we were talking about one company that had decided to do it their way; am I correct in that there were three companies taking oil, or what?

Mr. NELSON. I cannot address the methods of a specific company, Mr. Sisisky.

Mr. SISISKY. The amount of loss that you talked about was of one company, if everybody did it that way, what would be the loss——

Mr. NELSON. No, that would be one company. As a matter of fact, in the information that I handed out in my press conference in early August that was handed to me by the GAO, it shows quite a few companies—13 companies—with three companies producing most of the crude oil.

Mr. BEDELL. Would the gentleman yield?

Mr. SISISKY. Yes.

Mr. BEDELL. The previous testimony that we have had indicates that Arco Petroleum, in particular, has used a different method of computation than have the other companies. Indeed, the methods of computation by all of the companies are subject to question. However, there had been testimony to indicate that if they all used the Arco method, it would significantly reduce the taxes of the others as well.

Mr. SISISKY. Well, I am not satisfied at all. You know, it seems amazing to me that you had to ask for a GAO study, rather than an Internal Revenue study.

Mr. NELSON. Well, the GAO works for the legislative branch.

Mr. SISISKY. I understand why you did it, but I just cannot, in my mind, understand why the problem is not resolved by the Internal Revenue Service, and particularly in that length of time. Now, as far as the statute of limitations, has the Internal Revenue filed suit so that the statute of limitations will not run out in any of these cases?

Mr. NELSON. Well, I don't know the answer to that. I raised the question at my press conference: Was there a private agreement or waiver between the oil companies involved and the IRS where the oil companies would have agreed not to have the statute of limitations in effect?

I do not know the answer to that, and I think you all ought to find that out from the IRS when you meet.

What I postulated to you this morning is that if, in fact, such agreement has not been in effect, in essence, we have lost the revenues that have been understated to the Federal Government in that period outside the limit of 3 years.

Mr. SISISKY. The clock keeps ticking.

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Mr. NELSON. The clock keeps ticking.

Mr. BEDELL. Would the gentleman yield?

Mr. SISISKY. Yes.

Mr. BEDELL. I think we should make it clear to everyone that the chairman was very disappointed that IRS refused to come and testify before our subcommittee. However, in fairness to them, it seems only appropriate to the chairman that we meet with them privately to see whether or not we could get answers to the questions.

Certainly, there is an opportunity for the subcommittee, if it wishes to do so, and if we do not get answers we need, to subpena the IRS, to require them to testify before.

I feel we should cooperate with them to the extent we could before we go ahead and have a confrontation with them.

Mr. NELSON. Now, apparently, in defense of the IRS, and you know all of these——

Mr. BEDELL. Or the Treasury, I should say.

Mr. NELSON. Answers will become apparent over the course of time in your investigation.

Apparently, there was the cooperation of the IRS with the GAO. The information that the GAO is coming forth in this report and it has been supplied to me orally, was obtained from the IRS. So there is that degree of cooperation.

But I think what Mr. Sisisky has raised is a very legitimate question: Why does there appear to be footdragging on the part of the IRS to come forth with regulations, if they recognize in fact, as they have said to GAO, there is a problem, when they estimate that it is $500 to $800 million a year in lost revenue?

Is there some question as to the validity of their comments? We don't know, but we know that is what they said.

Mr. BEDELL. Would the gentleman yield further?

Mr. SISISKY. Sure, Mr. Chairman.

Mr. BEDELL. I think it will also be clearly shown in our hearings that the ruling that they have come out with is very ambiguous. There is a big question as to exactly what the ruling means and what it says.

Mr. SISISKY. I just understand from counsel over there, that there was a waiver signed yesterday, Mr. Chairman, between Arco and the Treasury Department. That is what I just heard.

My real problem is, you know, the Internal Revenue Service, as you said, started a study on regulations in 1982. Why not 1980? Why wait? When you are talking about this huge amounts of money——

Mr. NELSON. Sure.

Mr. SISISKY. It is amazing to me, and I would——

That is all, Mr. Chairman.

Mr. BEDELL. Mr. Bilirakis.

Mr. BILIRAKIS. Mr. Chairman, I think we are probably very quickly at the beginning of this entire session coming to the conclusion that it is going to be difficult to even come to a bottom line without the IRS being involved, and I commend you for your effort in trying to get them here, and I just don't think there is any excuse for it at all.

I do understand that there may have been signed waivers by the oil companies as far as the statute of limitations is concerned. I suppose we can go into that when——

Mr. NELSON. Then, that is certainly information that we should know.

Mr. BILIRAKIS. Yes, and I understand that we, again, cannot get that from the IRS. I am not sure that I am accurate as far as that is concerned, but certainly we ought to know that.

Congressman Nelson, by the way, your press release is headed Ninth Congressional District. That is now my district, Bill, as the result of redistricting in Florida. [Laughter.]

So, I appreciate——

Mr. NELSON. I well recognize that. We are trying to use up some of the old stationery. [Laughter.]

Mr. BILIRAKIS. You're a fiscal conservative. I commend you for that.

Mr. NELSON. That's right, Mike. [Laughter.]

Mr. BILIRAKIS. You personally have not been able to sit down with these people, including IRS to determine—I understand that there is a legitimate difference of opinion in here in terms of interpretation of this very complicated Revenue ruling, which finally has come forward, in the original intent of the windfall profits tax and its formula.

It certainly is very significant. I know the chairman is just as concerned about this as all of us are that know of innuendos that get out that would place the blame or the fault completely on the oil companies themselves if they do not deserve that fault.

It seems that really it ought to fall upon the IRS because of their failure to come up with adequate clarity, if that, in fact, is the case.

I have nothing further, sir, of the Congressman. I would just commend him for his great interest.

Mr. BEDELL. Thank you very much, Mr. Bilirakis.

Mr. Ray.

Mr. RAY. No questions.

Mr. BEDELL. Mr. Britt.

Mr. BRITT. Bill, do you have any sense of what is causing the delay in the regs. Of course, it is always a lengthy process, but do you sense if there is any deliberate footdragging or if it is just an administrative problem?

Mr. NELSON. I don't have that evidence, Robin. I am looking forward to this meeting today with Treasury to determine the cause of the delay.

That is an appropriate role for this Congress. When our forefathers set up this system, they seemed to know what they were doing; for us to have the checks and balances over the administrative agencies of the Government is a proper role for us to fulfill. Certainly, since we set the fiscal policy of this Nation in the crunching deficits that are now facing us, this is of primary concern. We ought to get on with this right away.

Mr. BRITT. I would just like to commend you for your efforts.

Mr. NELSON. I might say, Mr. Chairman, that I wanted to make sure that none of my staff could demagog this issue because of the obvious publicity appeal. Thus, over several months of the summer, we had these meetings with the GAO. I instructed my staff to con-

duct these meetings in a most deliberative manner so that there was hard evidence and that there wasn't any question in the GAO staff's mind, as to what they were forthcoming with in their report. I did not want to be accused of being involved in just another case of trying to beat up on the big oil companies. I tried to conduct that August press conference in such a manner that was deliberative and without political thrashing. I think after all our deliberations that we have got something here that is worth investigating further.

We know there is a problem. We ought to correct it in short order.

Mr. BRITT. No further questions, Mr. Chairman.

Mr. BEDELL. We certainly thank you very much for your contribution to this effort, Bill. The subcommittee will be adjourned for about 15 minutes while we go over and vote.

You are certainly welcome and encouraged to join with the subcommittee upon our return.

The subcommittee will be in recess.

[A short recess was taken.]

Mr. BEDELL. Back on the record.

Our next speaker will be Mr. Edward Modell, of the Independent Gasoline Marketers Council.

Mr. Modell.

TESTIMONY OF EDWARD G. MODELL, ON BEHALF OF THE INDEPENDENT GASOLINE MARKETERS COUNCIL

Mr. MODELL. My name is Edward Modell, and I am appearing on behalf of the Independent Gasoline Marketers Council, a trade association of nonbranded independent retailers of motor gasoline.

Before beginning my testimony, I want to apologize for the inability of Mr. Blum to be here today. He is in California appearing before the Federal district court, where Mr. Blum is asking that a protective order be modified so that the public can have access to 10 years of discovery and pleadings which have remained under seal at the request of the major oil companies, involved in that litigation. Although Mr. Blum has been known to be in more than two places at one time within the city of Washington, the coast-to-coast distances made that feat impossible, even for Mr. Blum today.

As the committee knows, the council testified before the committee in December 1982 about its difficulties with competitive tactics of the Atlantic Richfield Co. In particular, the council told the committee it believes Atlantic Richfield is improperly calculating windfall profit taxes due on production of Alaskan North Slope crude.

The methodology that Arco is using has permitted it to underpay windfall profit taxes by a significant amount, and this underpayment in turn has permitted Arco to post retail prices which are below wholesale gasoline prices that prevail in the same area. The result of the continuation of this pricing policy has been the destruction of the independent refining sector in PADD 5 and the destruction of a significant portion of the independent marketing sector. Many independents, in fact, have been forced to seek brand cover with Arco and other majors. None of this bodes well for the long-term consumer or small business interests.

Arco has created an arbitrary and artificial transfer price for crude oil into its west coast refining center. It can do this because it makes no arms-length sales of Alaskan North Slope crude oil on the west coast which would fix a market price.

The lack of a true market price permits it to establish the transfer price through an elaborate series of calculations which Arco claims are based on a formula permitted by the tax laws.

Our analysis of Arco's pricing methodology leads us to the conclusion that its method understates the value of the crude delivered on the west coast by some $3 per barrel.

The analysis is based on public information derived from the Petroleum Revenue Division, Department of Revenue, State of Alaska, and Platt's Oilgram Price Report. In fact, attached to our statement is a breakdown showing how we have arrived at the $3 value understatement.

We believe that the money that Arco is saving by understating the value of its crude is being used to systematically destroy independent competition in the markets Arco wishes to dominate.

The Revenue ruling recently issued by the Treasury Department subject to this hearing does not address this problem. It addresses itself to the question of whether a company may use the Department of Energy's valuation methodology as a way of determining removal prices for Alaskan North Slope crude. The ruling answers the question by stating that a company may not use the DOE methodology, and that the section 613 methodology applies.

Unfortunately, the more compelling question Treasury must answer, as we see it, is not whether the section 613 methodology applies, but rather how the methodology in section 613 must be applied and even more fundamentally, of a Revenue ruling rather than a Treasury decision, proclamation, or regulation, which was alluded to earlier in this hearing.

I am sure the committee is well aware, Revenue rulings rank well down in the hierarchy of Treasury tools.

Given the sums of money involved, the competitive issues and the potential losses to Treasury, a more forthright and authoritative position must be taken. Taxpayers must be on notice that aggressive positioning on tax issues will lead to penalties and possible criminal prosecution. The money in question should be paid to Treasury in a timely fashion.

IGMC would like to urge this committee to continue to press the Department of the Treasury for an immediate solution, or alternatively to prepare a legislative recommendation for the Ways and Means Committee.

If the committee has any questions, I would be very happy to answer them at this point.

Thank you.

[Mr. Modell's prepared statement follows:]

PREPARED STATEMENT OF EDWARD G. MODELL, ON BEHALF OF THE INDEPENDENT GASOLINE MARKETERS COUNCIL

My name is Edward Modell. I am appearing on behalf of the Independent Gasoline Marketers Council, a trade association of nonbranded independent retailers of motor gasoline.

As you know, the Council testified before this Committee in December 1982 about its difficulties with competitive tactics of the Atlantic Richfield Company. In partic-

ular, we told you that we believe Atlantic Richfield is improperly calculating windfall profits taxes due on production of Alaskan North Slope crude. The methodology Arco is using has permitted it to underpay windfall profits taxes by a significant amount and this underpayment, in turn, has permitted Arco to post retail prices which are below wholesale gasoline prices that prevail in the same area.

The result of the continuation of this pricing policy has been the destruction of the independent refining sector in PADD 5 and the destruction of a significant portion of the independent marketing sector.

Tosco, a once healthy independent refiner, is being run by its creditors and is the subject of a spate of merger rumors. Powerine, another independent, is now processing crude oil for Arco's account after a period during which Powerine flirted with Chapter 11. Other independent refiners are in similar condition.

The marketing sector has also grown weaker. Many independents have been forced to seek brand cover with Arco or other majors.

None of this bodes well for the long term consumer interest.

Arco has created an arbitrary and artificial transfer price for crude oil into its West Coast refining center. It can do this because it makes no arms-length sales of Alaskan North Slope crude oil on the West Coast which would fix a market price. The lack of a true "market price" permits it to establish the transfer price through an elaborate series of calculations which Arco claims are based on a formula permitted by the tax laws.

Our analysis of Arco's pricing methodology leads us to the conclusion that its method understates the value of the crude delivered on the West Coast by some $3.00 per barrel. The analysis is based on pubic information derived from the Petroleum Revenue Division, Department of Revenue, State of Alaska, and Platt's Oilgram Price Report.

More specifically, the value of products refined from crude oil run through an average refinery on the West Coast during 1982 was $1.20 per barrel higher than the average refinery yield on the Gulf Coast. However, during 1982 Arco reported an average transfer price on the West Coast for its North Slope crude oil which was $1.80 below the transfer price reported for crude oil delivered on the Gulf Coast. This result is preposterous and cannot be what the Congress intended when it wrote the windfall profits tax.

I have attached to my statement a table of Arco's transfer prices for Alaskan North Slope crude in 1982 as reported to the State of Alaska, and refined product values derived from Platt's Oilgram.

We believe that the money that Arco is saving by understating the value of its crude is being used to systematically destroy independent competition in the markets Arco wishes to dominate.

The Revenue Ruling recently issued by the Treasury Department does not address this problem. It addresses itself to the question of whether a company may use the Department of Energy's valuation methodology as a way of determining removal prices for Alaskan North Slope crude. The Ruling answers the question by stating that a company may not use the DOE methodology and that, in fact, the § 613 methodology applies.

Unfortunately, the more compelling question Treasury must answer, as we see it, is not whether the § 613 methodology applies, but rather how the methodology in § 613 must be applied and even more fundamentally, whether the transportation charges that Arco allegedly is levying against itself are reasonable.

As we have said before, we don't think that Arco's charges to itself for the use of its tankers or for passage through TAPS can stand up to careful examination.

Unless the Treasury Department resolves this issue in a forthright and unmistakable way, it will be resolved through the audit and litigation process which will take several years. In the meantime, all of the truly independent competition in Arco's marketing areas will be destroyed and the Treasury will be deprived of hundreds of millions of dollars in revenue.

It is also essential that the Committee bear in mind that the audit period for the very first windfall profits tax filed on Alaskan North Slope crude will not be up for another several months. The amounts of money at stake guarantees that each of the companies involved in North Slope production will be vigorously contesting IRS attempts to recover amounts it believes are due and that the dispute will carry on for a substantial number of years.

We are further distressed that the Treasury Department's alleged "remedy" to the problem is in the form of a Revenue Ruling rather than a Treasury Decision, Proclamation or Regulation. As I am sure the Committee is well aware, Revenue Rulings rank well down in the hierarchy of Treasury tools. They are non-authorita-

tive and non-binding, although they have some precedential value and certainly give taxpayers guidance as to the present thinking of the Service.

Given the sums of money involved, the competitive issues and the potential losses to the Treasury, a more forthright and authoritative position must be taken. Taxpayers must be on notice that aggressive positioning on tax issues will lead to penalties and possible criminal prosecution. The money in question should be paid to Treasury in timely fashion.

We urge this Committee to continue to press the Department of Treasury for an immediate solution or, alternatively, to prepare a legislative recommendation for the Ways & Means Committee.

AVERAGE SALES PRICES AND REFINER MARGINS FOR ANS IN 1982

1982	West price	West yield	West margin	Gulf price	Gulf yield	Gulf margin
January	29.60	36.39	6.79	30.99	34.76	3.77
February	28.63	35.72	7.09	29.18	33.93	4.75
March	27.00	35.09	8.09	28.38	31.87	3.49
April	27.00	34.70	7.70	28.50	33.72	5.22
May	27.43	35.31	7.88	29.09	36.20	7.11
June	28.54	36.40	7.86	30.29	35.93	5.64
July	28.43	37.18	8.75	30.29	34.98	4.69
August	28.27	36.79	8.52	30.31	35.35	5.04
September	28.17	36.55	8.41	30.63	36.25	5.62
October	27.72	36.60	8.94	30.56	36.63	6.07
November	28.09	36.56	8.47	30.03	34.78	4.75
December	27.42	34.43	7.01	29.36	32.21	2.85
Average	28.02	35.98	7.96	29.80	34.72	4.92

Source: Petroleum Revenue Division, Department of Revenue, State of Alaska, and Platt's Oilgram Price Report.

Mr. BEDELL. Thank you very much, Mr. Modell. Mr. Chisholm.

Mr. CHISHOLM. Thank you very much, Mr. Chairman.

TESTIMONY OF PHILLIP R. CHISHOLM, EXECUTIVE VICE PRESIDENT, NATIONAL OIL JOBBERS COUNCIL

Mr. CHISHOLM. My name is Phil Chisholm, and I am the executive vice president of the National Oil Jobbers Council. The NOJC is a federation of 42 State and regional associations which represents some 12,000 independent small business petroleum product marketers. These marketers, we estimate, roughly market half the gasoline and 85 percent of the home heating oil sold in the country.

To begin with, Mr. Chairman, I would like to commend you and the members of the subcommittee for your continuing interest in this critical tax compliance issue, particularly the confusing Internal Revenue Service ruling on the tax computations on windfall profits.

This issue has been of grave concern to gasoline marketers primarily because in public statements before Congress, the three primary producers have testified to at least two very different methods being used to calculate removal price of ANS crude oil, resulting in comparatively unequal tax payments by these companies to the Federal and State governments.

These diverse interpretations are having a grave impact on the motor fuel marketing industry, as at least one North Slope producer would appear to be using profits obtained as a result of a liberal interpretation of the law to unfairly increase its share of certain gasoline markets.

The differing interpretations should also be a major concern for every Member of Congress and the Reagan administration.

As Mr. Nelson so aptly pointed out, the GAO's found that the Federal Government is losing approximately $500 to $800 million a year in revenues as a result of the underestimate of the wellhead price of the Alaskan North Slope crude oil.

Revenue losses of this magnitude are inexcusable in an era when the Federal deficit is approaching $200 billion.

NOJC and our counterparts in the petroleum industry have for some time urged the Department of the Treasury to investigate this vast underpayment of State and Federal taxes by producers.

While we acknowledge that the windfall profits tax is a complex, arcane body of law, it is clear from the legislative history that Congress intended the law to be interpreted in a precise manner which sets up a uniform and correct methodology, particularly for North Slope crude oil which currently has no market value at the wellhead.

The Internal Revenue Service's recent ruling is woefully inadequate and strikes us as a politically expedient exercise that has caused greater confusion and may cause greater competitive harm for its members.

The ruling is so vague and nonbinding that many companies still do not understand exactly what it means.

Rather than narrowing or better defining the differing interpretations, the ruling raises perhaps further questions and could result in an even greater revenue loss to the Treasury.

This issue must be resolved in a meaningful way. Given IRS performance on the revenue ruling, the burden may fall on Congress. Until Congress clearly solves this problem, some companies will continue to exploit the system and use their underpayment of taxes to unfairly subsidize their motor fuel marketing operations.

NOJC contends that it never was the intent of Congress to provide companies a free hand in determining the amount of windfall profits tax owed to the Government. Nor was it the intent of Congress to allow the tax laws to be used unfairly to discriminate against other independent petroleum marketing companies.

As a result of the revenue ruling, the situation, as it now exists, would almost be akin to Alice in Wonderland. Arco, the company which would appear to have most underpaid windfall profits taxes as a result of its interpretations of the law, is claiming that the IRS ruling vindicates its actions.

If Arco's interpretation is correct, it could mean that the two other major ANS producers, Exxon and Sohio, could claim to have overpaid taxes in recent years.

I cannot believe that these companies overpaid taxes intentionally. I would also suggest that neither company will continue such overpayment if the Revenue ruling remains open to a variety of self-serving interpretations.

Marketer concerns with the Revenue ruling are essentially twofold: First, we believe that all taxes fairly owed to the Federal Government should be collected before additional sources of revenue are sought. This is of major concern to us, since too often when new sources of revenue are discussed, the major focus appears to be on some form of energy consumption taxes. The brunt of such

taxes, including motor fuel excise tax increases and import fees, are primarily borne by the small business petroleum marketers and the consumers they serve.

Second, and perhaps most importantly, is the downstream effect which these tax breaks appear to be having on the motor fuel marketplace. For 2 years, absolute chaos has reigned as marketers and refiners have scrambled for marketshare.

It appears that marketing efficiency is no longer the determining factor on which companies survive this battle. After all, companies which sell a product for less than its net back value are able to build marketshare without concerning themselves with efficiency.

The more critical determinant currently appears to be a company's ability to use income from another source within the company to subsidize its marketing operations.

As you know, Mr. Chairman, this has long been a concern of independent marketers. Now the situation is worsened considerably by any company utilizing the dollars which rightfully belong in the Federal or State treasuries to subsidize retail markets.

An analysis by the House Energy and Commerce Committee on Oversight and Investigations indicated that the differing methods of calculations of the removal price of Alaskan North Slope crude oil gave Arco a $2-per-barrel competitive advantage. As a result of this, the same subcommittee estimated a windfall profits tax revenue to the Federal Government in 1982 of some $200 million.

For competing gasoline marketers, that competitive advantage is approximately a nickel per gallon. Their effects on independent competitors have been devastating.

Several independent refiners which have been a source of competition for major integrated companies on the west coast have either closed down or entered processing agreements with Arco. Trade press reports in recent weeks have indicated that some independent marketers who have not yet been forced out of business may be adopting an "if you can't beat 'em, join'em" strategy, and are now branding their stations as Arco.

It is clear to us that the independent marketer who operates in any market in which Arco is exercising its dominance is virtually doomed unless Congress takes action. The meaning of all this is clear. Arco with the ANS advantage cited by GAO and the Oversight and Investigations Subcommittee has gained control of several retail gasoline markets.

Those small business competitors and customers, who have tried to stand in the way of this control have been driven to their knees. Consumers who are generally unaware that the Arco prices they currently love may be a result of tax underpayments, may be stunned to learn in a few years that Arco, or any other major company in a similar position has firm control of the retail market, and is therefore not subject to the healthy competitive pressures traditionally brought to bear by the independent segment of the industry.

Mr. Chairman, Congress must act immediately. Within the bureaucracy, gasoline marketers have found themselves in a Catch-22 position, in which you go to the IRS, explain the problem that you are facing, and IRS response has typically been that we will collect our money eventually through the audit process, if necessary. Un-

fortunately, that takes several years. IRS is firm in pointing out that they are not in the business of preserving gasoline competition.

You go to the Federal Trade Commission and you explain the situation to them, and they often say that it sounds like a tax problem; go see the IRS.

It is clear again that Congress must intervene on two fronts. First the ANS windfall profits tax issue must be clarified by legislative action, if necessary, before millions and millions of additional Federal dollars are lost.

Second, the line that is currently being advanced by many companies that the existing laws are adequate to protect independent marketers is rapidly becoming one of the three big lies of the 1980's. The other two are, "The check is in the mail," and "My Mercedes is paid for."

Additional protections are needed and NOJC has spent a considerable amount of time drafting very specific amendments to existing laws which are designed to promote and enhance competition in gasoline marketing.

Since this hearing is not designed to address that issue, I will not comment further on those recommendations but would be happy to discuss them in detail with the chairman or other members of this committee.

Thank you very much for the opportunity to testify this morning.

Mr. BEDELL. Thank you, Mr. Chisholm.

Mr. Sisisky.

Mr. SISISKY. Mr. Chisholm, in just very simple language, explain to me how the system works of Arco, how their pricing is set up to give them that price advantage in the markets that we are talking about.

Mr. CHISHOLM. I will try in very simple language, Mr. Sisisky, with my interpretation of it.

As I understand, the way Arco is doing it, they pump crude oil out of the ground on the Alaskan North Slope, bring it down the Trans-Alaska Pipeline, and put it on their own tankers and transport about 75 percent of it to the west coast. Now, with their interpretations of the windfall profits tax, they are saying that in calculating the removal price of that crude oil at the wellhead they are using a comparable crude oil in the gulf coast, west Texas sour crude oil. They consider the competing market for that crude oil to be the gulf coast.

Mr. SISISKY. Excuse me; I am talking about how they compete against the smaller jobbers and oil companies in marketing the oil.

Mr. CHISHOLM. OK. What they have in the past 2 years consistently been several cents a gallon under competing retail prices on the street.

Mr. SISISKY. Excuse me. Does that price vary from market to market, or corner to corner?

Mr. CHISHOLM. Yes.

Mr. SISISKY. What does the Justice Department——

Mr. CHISHOLM. Well, Arco claims they have retail price zones, which they have developed within their own company, and at one

point they testified to some 700 to 800 different retail price zones, at which they priced——

Mr. SISISKY. 700 to 800?

Mr. CHISHOLM. Throughout the country. Differing retail pricing—Mr. Bedell.

Mr. BEDELL. Will the gentleman yield?

We had Arco before our subcommittee previously, and they would not tell us what those zones were, nor was that information available to anybody else.

Mr. CHISHOLM. That's correct. They claim that they recognize their liabilities under the antitrust laws, and that their legal counsels have approved all these price zones, and that the price zones are setup on a competitive basis to meet competition, but they do have some 700 to 800 price zones. Competitors who are also wholesale customers conceivably could be in a different zone.

There was a trade press report last spring which came out of a supposedly internal FTC analysis, which showed Arco price differentials between Arco stations in Phoenix by as much as 13 cents a gallon between stations, depending on what market they happen to be in. There's also been differentials between the wholesale and retail level where in many markets the retail street price Arco is charging could be higher than their wholesale price.

Mr. BEDELL. Would the gentleman yield?

Mr. SISISKY. I'm just flabbergasted.

Mr. BEDELL. If I remember correctly, they also testified that they had the freedom themselves to change those zones at their own will, and to transfer a station out of one zone into another.

Mr. CHISHOLM. They all frequently change. We have jobbers who often wonder why they are seemingly out of the competitive zone that the dealer may be in. The Arco station they own has a price considerably higher than other Arco stations because they're not the same zone that a Arco retail customer may be in. We think Arco's ability to do that hinges back to the advantage they get on the crude oil on the North Slope.

Mr. BEDELL. Mr. Bilirakis.

Mr. BILIRAKIS. Mr. Modell, in your statement, you refer to the distinction in prices there. Could you, in more detail, briefly as you can, clarify that? I'm not quite clear on what's your intention.

Mr. MODELL. Certainly. I skipped over that in summarizing my statement, but let me address it.

It refers also to the chart that's attached to the statement. We believe that Arco is understating its value on its Alaskan crude oil by $3 a barrel. Part of the evidence of that is that the value of products refined from crude oil that went to an average refinery on the west coast during 1982 was $1.20 a barrel higher than the average refinery yield on the gulf coast.

Mr. BILIRAKIS. Why would it be $1.20 higher on the west coast versus the gulf coast? Let's just go into that——

Mr. MODELL. In terms of the yield from refineries. As you see, according to the information we have in the west coast, it was $35.98 per barrel yield as an average during 1982, on the west coast. And on the gulf coast $34.72. Market conditions, for the most part, I think, would have to do with the yield, or the dollar value of the products refined from the barrel of crude oil.

Mr. BILIRAKIS. Is that the result of the difference in the characteristics of the crude?

Mr. MODELL. That may be true in terms of yield from an average refinery. It could take refinery differences into account as well. I would think during 1982 for the most part, market conditions may have set the value of the yield from a barrel of crude oil.

Mr. BILIRAKIS. That couldn't be the result maybe of better efficiency in one locale versus another, and that sort of thing? You know, the free enterprise system at work?

Mr. MODELL. Could be. It's supposed to be, and it could also be the amount of product available, and various other market conditions.

Mr. BILIRAKIS. OK.

Mr. MODELL. But on the other end, we look to the transfer price, as we understand it, that Arco's been reporting for west coast deliveries, and gulf coast deliveries. We find that on the west coast an average for 1982 was $28.02 a barrel, as opposed to the gulf coast where it's $29.80 a barrel. Where on the west coast it was $1.80 below the transfer price for gulf coast delivered crude oil, which the result of all of that is, on the west coast we show up what we think might be a margin for Arco of almost $8 a barrel for crude oil from Alaska during 1982, and the gulf coast about $5 a barrel, or $3 a barrel overall difference. Assuming that perhaps a $5 a barrel margin might be appropriate, they've understated the value, and all this comes about to the understating of the value of the Alaskan North Slope crude oil.

Mr. BILIRAKIS. So you're attributing all that to the less windfall profits tax being paid.

Mr. MODELL. They paid it differently. They could have supported a higher price by $3 a barrel on the west coast for their Alaskan North Slope crude oil for windfall profits tax purposes, and come up with the same margin they were making on the gulf coast.

Mr. BEDELL. Would the gentleman yield?

Mr. BILIRAKIS. Yes.

Mr. BEDELL. I think the argument is that the transportation costs from California to Texas are significantly higher than any price differentials. So that if you price the oil at the Texas price, and you're going to deduct the transportation costs, you come out with a significantly lower price than you would if you took the California price, even though 70 percent of the oil is used in California.

Mr. BILIRAKIS. So the difference then is not the result of use or misuse of windfall profits tax formula, it's basically the transportation costs?

Mr. BEDELL. Yes. The question is whether it is proper, since the oil is used in California, to base the value of it on Texas prices rather than California prices. By using Texas prices, since the transportation cost is significantly greater than the price differential, you avoid significant taxes by using the Texas price.

Mr. MODELL. Remember also for each dollar of additional transportation they can use to deduct from the removal price on Alaskan North Slope is 70 cents' worth of tax savings.

Mr. BEDELL. Going back to the first page of your statement, Mr. Chisholm, the result of the continuation of this pricing policy has

been destruction of a significant portion of the independent marketing sector in the Pacific coast.

How widespread might this phenomenon be in terms of the entire United States and the entire marketing sector? This issue really concerns Small Business Committee more than anything else?

Mr. CHISHOLM. Arco has testified that they only have about 4 to 5 percent of the national market. I believe last year, before this committee, they pointed out how could their 4 or 5 percent of the national market be creating all of these problems. When you look at them in the markets, they are dominant on the west coast, in Pennsylvania, and some of the other markets, they have a considerably higher earnings, perhaps 25 to 30 percent of the market in some cases.

In those markets, independent marketers are virtually unable to compete. They are being economically divorced out of those markets. If they want to survive they had better get out and go somewhere else. The unfortunate situation is that it is not only occurring now in those markets dominated by Arco, but it is now beginning to occur in other markets as other refiners try to do other types of strategies to engage in the same type of activity. The point I made in the statement is that efficiency has no relevance in the marketing of gasoline.

Mr. BILIRAKIS. Are there any other parts of the country where Arco is not operating? Where there are gaps in the prices charged to the ultimate consumer, you know?

Mr. CHISHOLM. Yes.

Mr. BILIRAKIS. Do you see what I'm getting at?

Mr. CHISHOLM. Yes. There are other instances.

Mr. BILIRAKIS. Well, what's the result? We apparently were deciding here that the windfall profit tax is the result of Arco's customers being impacted adversely. Not the customers, but the independent marketers being impacted adversely. What would be the reason for the same thing happening in other locales which Arco does not service?

Mr. CHISHOLM. There would be a number of factors. We have alleged for many years that the ability in major integrated companies with profits in crude oil production, and refining, and in marketing, was to be able to subsidize their downstream operations in such a way as to build market share; that's one possibility.

Primarily, the diverse operations of the company, being able to penetrate retail markets, and use profits from other profit centers, the independent marketers do not have, and are unable to compete with. There may be many other explanations of the tax laws. You could get into a lot of differing rationales for that.

Mr. BILIRAKIS. Thank you, sir. I have no further questions. Mr. Chairman, thank you.

Mr. BEDELL. Thank you, Mr. Bilirakis.

Mr. RAY. Mr. Britt.

Mr. BRITT. Mr. Chisholm, have the jobbers attempted to sit down with Arco and air these complaints, and what came out of those discussions?

Mr. CHISHOLM. Mr. Britt, that's an interesting question, particularly at this point in time.

At each of our annual meetings we have what we call brand meetings, where the jobbers for various suppliers sit down and discuss with their supplier what's going on with their company, why they're engaging in certain practices.

On a national basis, to the best of my knowledge, Arco has not engaged in one of those brand meetings for almost 2 years with their customers. They have done it, I think, on some States, and on regional basis, but on national basis they have not engaged in any type of constructive dialog with their customers.

We understood that they would be at a meeting we were having in Atlanta, and would sit down with their customers on a national basis. Because Arco is currently involved in litigation with a number of jobbers on the west coast about some of their marketing practices, it has since refused to come to Atlanta if those jobbers were allowed to be in the room.

As an association, we cannot prohibit those jobbers, nor ethically would we want to prohibit them from being in the room, so it appears that once again they will not meet with their jobbers.

Now, the NOJC leadership has met with Arco on a 1- to 1-basis, and tried to discuss these problems. Arco has consistently stated their position is that their ability to market cheaper than anyone else is based on their superior efficiency over other refiners, and over other marketers.

As a general rule, we have a difficult time accepting that argument.

Mr. BRITT. No other questions, Mr. Chairman.

Mr. BEDELL. Thank you. Mr. Boehlert.

Mr. BOEHLERT. Yes. Mr. Chisholm, I'd like to know if there's some way we can determine the impact of the alleged underpayments? Where Arco is biggest and strongest, is there any pattern over the last 3 years increasing the amount of their share in that given market?

Mr. CHISHOLM. No question, on the west coast, and in Pennsylvania. They have substantially increased their market share in those markets. I do not have precise numbers. I'm sure they're available, and we can find them, but on the west coast, and in Pennsylvania, those two markets they have substantially increased their market share.

Mr. BOEHLERT. At a subsequent time could you give us that information for the record?

Mr. CHISHOLM. Yes.

Mr. BOEHLERT. I'd like to have that.

[The information referred to above follows:]

National Oil Jobbers Council
1707 H Street, N.W., 11th Floor
Washington, D. C. 20006 202/331-1198

September 21, 1983

Hon. Berkley Bedell, Chairman
House Small Business Committee
Subcommittee on Energy, Environment and Safety
Issues Affecting Small Business
2459 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

During the recent hearing held by your Energy Subcommittee on the IRS Revenue Ruling 83-124 concerning Alaskan North Slope crude oil, I was asked by Representative Boehlert to provide documentation on the increase in ARCO's marketshare in key markets. I am hereby responding to that request for the record.

NOJC, as an association, does not collect marketshare data. Rather, it relies on published industry reports. The basis for my statement that ARCO's marketshare had increased substantially is based on those reports.

On a national basis, Time magazine reported (April 18, 1983), that in 1982 ARCO increased its marketshare from 3.8 percent to 4.8 percent, a 21 percent increase. This increase is even greater when one considers that ARCO, by its own admission, is rapidly condensing and consolidating its operations into certain key markets and that therefore this 21 percent increase in 1982 was not spread nationwide, but rather was focused in those key markets.

To assess accurately how ARCO has increased its marketshare in several key markets, NOJC contacted the Lundberg Letter, published in California. According to Lundberg, from the beginning of 1982 through August, 1983, ARCO has increased its marketshare in California by 23 percent, moving from 11.2 percent to 14.6 percent. TOSCO in its testimony indicated that for the Petroleum Allocation District V (PAD V), which encompasses the entire West Coast, ARCO's marketshare jumped over 30 percent, from 9.25 percent to 13.36 percent. Interestingly, PAD V is where 75 percent of ARCO's North Slope crude oil is delivered, refined and sold.

According to Lundberg, ARCO's marketshare in Pennsylvania rose 22.6 percent in 1982, from 17.9 percent to 23.1 percent. This means, effectively, that a single company, ARCO, controls nearly a quarter of the Pennsylvania gasoline market.

To give the Subcommittee an even better idea of the impact of ARCO's pricing policies, one can examine taxable gasoline sales. According to California state tax numbers, ARCO, in April 1982, increased its gasoline sales as opposed to the same month of 1981, by 3.18 percent. In the successive months of May-August, the company increased sales by 12.29 percent, 55.67 percent, 16.37 percent, and 40.64 percent respectively over sales in the same months of 1981. Sales do not necessarily translate into marketshare increases since several other major companies also increased sales in those months. No company, however, had increases every month as did ARCO, nor were the increases of the magnitude of ARCO's. Overall the majors' gasoline sales were down .23 percent in April, and up 2.39 percent, 3.75 percent, 4.42 percent and .56 percent for the period May through August.

Independents for the same period of time had consistently falling gasoline sales of 4.5 percent, 17.79 percent, 12.35 percent, 7.6 percent and 1.23 percent respectively for the same five month period. The following chart shows this a little more clearly.

Comparison of 1981 - 1982 - Taxable Gasoline Sales - California

Month	Total (California)	ARCO	Majors	Independents
April	-1.05%	+3.18%	-0.23%	-4.5%
May	-1.72%	+12.29%	+2.39%	-17.79%
June	+0.27%	+55.67%	+3.75%	-12.35%
July	+1.88%	+16.37%	+4.42%	-7.6%
August	+0.17%	+40.64%	+0.56%	-1.23%

All of this data must be viewed in light of ARCO's zone pricing strategy and the company's ability and desire to focus these increases in several key markets or zones in which they were competing with other independent marketers.

It may be useful for the Subcommittee to review a series of articles which appeared earlier this year in an industry trade publication which were based on internal FTC memos. These articles speculate on how ARCO consciously decided to take on independents in the gasoline market rather than the majors in the crude oil market; how they utilize their Windfall Profits Tax advantage; how their actions may be a violation of antitrust laws; and how ARCO's wholesale price in some markets is higher than their retail price in the same market. I am attaching each of those articles for insertion in the record (see Attachment).

I hope this information answers any questions you might have. If I can be of further assistance, please call.

Sincerely,

Phillip R. Chisholm
Executive Vice President

PRC:cp
Attachment
cc: Representative Sherwood Boehlert

OIL EXPRESS February 14, 1983
exclusive report serving informed petroleum marketers nationwide

FTC secret memos charge

Arco pricing may break antitrust law

Arco's "insidious" price cutting may violate federal antitrust law, claim secret Federal Trade Commission (FTC) staff memos obtained by Oil Express.

The pricing results in jobbers paying more than dealers in some markets. And in other markets some Arco dealers pay up to 13cts/gal more for product than fellow Arco dealers just miles away. (See related story, p.5).

The memos call for a full probe of Arco's marketing activities.

Arco's cash-only, low-ball retail pricing, FTC staff allege, is critical to a larger strategy involving maximum use of Alaskan crude and possible evasion of Windfall Profits Taxes. Oil Express reported on those allegations last week.

But Arco's wholesale pricing practices may also violate federal antitrust law, according to the FTC documents and reported here for the first time.

Marketers and their attorneys who have complained to FTC make a "compelling case...that Arco is controlling the price of its retailers," the memos say.

"Arco is not only maintaining prices below the market clearing level but is buying gasoline on the spot market in order to do so. Given the prevailing levels of spot prices and Arco's lowest sales prices, the firm may be making some sales below marginal cost," FTC staffers say.

Arco has cut its prices much more than the savings achieved from dropping its credit card, the FTC staffers claim. "This raises the possibility that Arco's price behavior is short-run and is intended to eliminate competitors," one memo says.

Arco selectively concentrated price cuts in those areas where private branders had heavy market share, FTC staffers allege.

Arco attorneys have told FTC that unbranded jobbers don't get the same competitive allowances as branded dealers because such an offer is "unnecessary" since the gasoline isn't of like grade or quality. Besides, Arco says, jobbers could buy spot product if they wanted. But spot prices have ranged 4cts-10cts/gal above Arco's, the memo says.

Moreover, "By supposedly granting 'temporary competitive allowances' (TCAs) to its dealers in some areas and not others, Arco may be injuring both independent private-brand distributors that indirectly compete with Arco in the low-priced areas, and private brand retailers that compete with Arco dealers in those areas," says FTC.

"Arco compels adherence to price through a number of coercive practices, including price surveys, harassment (delaying repairs, failure to meet delivery dates, suggestions that leases will not be renewed), adjustment to the TCA and changes in station rent," marketers told FTC attorneys.

February 7, 1983 • Oil Express • 3

say secret FTC memos

Arco spares majors to attack marketers

Faced with a choice, Arco is opting to wage a possibly illegal war with independent marketers rather than take on other major oil companies, suggest secret Federal Trade Commission memos obtained by Oil Express.

Pointing at Arco's unusual retail pricing, puzzling crude oil postings and confusing tax data, the memos urge a full-scale investigation of Arco on grounds it may be guilty of tax avoidance and antitrust violations.

Key to Arco's strategy, FTC investigators believe, are ambiguities in the complex Windfall Profits Tax on crude oil that have enabled the company to offset gasoline marketing losses. (See related story, p.4)

Until the early '80s when West Coast gasoline demand fell, Arco could place all its Alaskan crude in its refineries. When demand fell, it faced a dilemma.

In a competitive market, Arco would cut its West Coast Alaskan crude price to move crude. But Arco feared that a price cut could lead to retaliation by sister Alaskan crude producers Exxon and Sohio, leading to lower crude prices but no gain in market share.

Shipping surplus crude to the Gulf--the obvious alternative--also presented problems. If Arco sells its West Coast refinery crude at artificially low prices, as FTC believes, then a sale at the true Gulf market price might tip off IRS to the difference between Arco's sales price and the price it charges its own refineries.

So Arco looked downstream and came up with a unique solution: by dropping its credit card it could slash gas-

"Arco, as a major Alaskan North Slope producer, could attempt to avoid (or...'evade') all but federal income tax by booking the crude oil into its refinery at an artificially low transfer price." --FTC memo

oline prices without provoking industry-wide "retaliation," say the staffers.

And by tying price cuts to the death of the card, Arco was able to signal other majors that it wasn't out to increase market share at their expense.

"For bookkeeping purposes, Arco would simply reduce its crude oil profits and increase its refining and marketing profits. Because downstream profits are taxed at a much lower rate than ANS (Alaskan crude) profits, this scheme may be financially attractive," say FTC probers.

To pull the crude through its refineries, Arco selectively cut prices to branded marketers, concentrating cuts in areas where private branders had heavy market share. Additionally, Arco "strong-armed" dealers to pass on low prices to consumers, FTC probers were told.

The results: in the third quarter of 1982, Arco refineries ran at about 100% capacity while other majors ran at 70%, and Arco's refining-marketing profits rose by over 24% over the year before.

"By taking evasive action at the marketing level of the industry, rather than taking on the ANS (Alaskan crude) producers directly, Arco may be driving innocent bystanders out of the market," investigators conclude.

IRS probing Arco...
IRS is probing whether Arco is cheating on its Windfall Profits Tax, says Rep. Berkley Bedell, D-Iowa. Bedell asked IRS to audit Arco after marketers claimed at recent hearings that Arco underpaid taxes to subsidize downstream ops.

FTC asks why?

Jobbers pay 3.15cts more than dealers

Fact: Arco unbranded rack jobbers in Belmont, Pa. paid 3.15cts/gal more for gasoline than dealers in April, 1982.

Fact: Some Arco Phoenix dealers paid nearly 13cts/gal more in April, 1983 than others just miles away.

These are just two examples of seemingly topsy-turvy postings stemming from Arco's zone pricing practices. Those practices are now being scrutinized by Federal Trade Commission investigators.

Arco has 222 pricing zones in Pennsylvania and 171 in California, say FTC memos. The zones are considered highly secret. Last April, Arco threatened to fire on the spot any employe who disclosed them.

The following chart, from FTC memos, show's Arco's DTW price and unbranded jobber price in six cities on April 23 or 24, 1982.

City	Arco zone	DTW price $/gal	Unbr. jobber $/gal	City	Arco zone	DTW price $/gal	Unbr. jobber $/gal
Stockton, CA	7085	.9175	.8830	Sacramento,	7055	.8860	.8830
	7420	.8760		CA	7065	.8570	
	7430	.8585			7070	.8670	
	7435	.8670			7075	.8480	
	7440	.8670		Phoenix, AZ	9702	.9465	.8845
	7445	.8480			9703	.9540	
	7450	.8290			9704	.9415	
	7455	.9050			9706	.8490	
	7480	.9150			9708	.8590	
					9711	.8690	
Woodbury, NJ	2201	.8505	.8480		9716	.9140	
	2202	.8490			9721	.9765	
	2203	.8590					
	2205	.8190		Belmont, PA	2101	.8245	.8465
	2206	.8190			2102	.8245	
	2207	.8490			2103	.8245	
					2104	.8340	
Culton, CA	9201	.8670	.8800		2105	.8150	
	9202	.8670			2106	.8150	
	9203	.8670			2107	.8150	
	9204	.9120			2108	.8340	

The Arco tax puzzle

• "The (Windfall Profits Tax) data presented to us by Arco cannot be interpreted in a consistent manner, even after an attempted reconciliation by Arco personnel." --FTC memo

• Arco's West Coast price for Alaskan crude fell 28cts from April to June, 1982 while Sohio's West Coast price rose $1.99.

• Arco's Windfall Profits Taxes for third quarter 1982 dropped from $292 million to $194 million at the same time Arco's overall volume increased 15%.

Conflicting Arco tax data has FTC staffers scratching their heads and asking for a full probe of Arco's activities. Spurred by complaints from marketers, FTC investigators have noted but not totally unravelled what seems to be a link between changes in Arco's reported Alaskan crude prices and the adoption of its low-ball, cash-only marketing strategy last spring.

That strategy has allowed Arco to expand its refining operation and transfer more Alaskan crude to its own refinery, they say. But there's more.

At the same time Arco started low-balling gasoline, it dropped its estimate of what its Alaskan crude was worth on the West Coast by 28cts, while Sohio's West Coast price rose $1.99. That estimate is part of the basis for paying Windfall Profits Tax, so a cut would lower taxes.

"Interestingly, Arco's valuation of ANS (Alaskan North Slope crude) at the producing field...did not fall below Sohio's until the month after Arco initiated its new gasoline marketing strategy," FTC investigators note.

After studying tax figures, FTC staffers have concluded Arco may be cheating on its West Coast taxes while Sohio and Exxon may be underpaying taxes on Alaskan crude shipped to the Gulf Coast.

What's the West Coast/Gulf Coast connection? Shipping crude to the Gulf increases Arco's transportation cost by $3.50/bbl or more. That could be used to lower its Windfall Profits Tax payments to Uncle Sam because tax is based on the sale price less cost of transporting it to market.

Because of ambiguities in the complex Windfall Profits Tax, IRS lets majors interpret it in their own way, Treasury officials have already admitted.

Arco decided to read the regs this way, FTC staffers theorize: ship surplus crude to the Gulf, peg sale price to West Texas sour, and subtract transportation costs from taxable sales. Then use that formula to apply to all Arco crude--even that refined on the West Coast which has a much lower transportation cost.

"It may be that Arco uses an above-market Gulf Coast price in order to make its more important West Coast prices look more realistic," say the staffers.

"In essence," say the investigators, "the tax avoidance scheme would subsidize the reduction in retail prices and increase the liklihood that retail price reductions would be profitable. The decline in retail prices would be partially offset by a tax savings on crude oil profits."

Mr. BOEHLERT. What's been the impact on the consumer?

Mr. CHISHOLM. I think the consumer has probably in the short term benefited from that type of activity. The prices have been lower, and they have benefited from those lower prices.

It would be our contention that, and I pointed that out in my statement, that the consumers may not have benefited as much as they think if it is determined at a later date that the benefits were to drop because Arco underestimated its tax payments.

Certainly over the long term, I think they will find they have not benefited when they find that Arco has successfully driven all competing independent marketers out of business. They virtually control the market with very little competitive pressures from the outside.

Mr. BOEHLERT. Well, can you directly relate the price to the increase share of the market, or are there other factors that would come into play?

Mr. CHISHOLM. In gasoline marketing, price is what sells. That's how market share changes. I've had people tell me they'll lose 10 percent of their market share if they are 1 cent a gallon out of the market. They can lose that over a matter of a few days. In gasoline marketing, because of its intense competitive nature, price seems to be the major determinant on gaining or losing market share.

Mr. BOEHLERT. No real product loyalty, name loyalty?

Mr. CHISHOLM. Not to the extent there used to be. I think a lot of that has occurred as a result of some of the marketing strategies of the major oil companies with their credit card, and discounts for cash programs, and things like that. People are now finding that, "Hey, I've been paying 4 cents a gallon, or 6 cents a gallon for using this credit card all along." Arco eliminated its credit card, and claimed major savings from that, which I'm sure they did have major savings. But I don't think those savings had any magnitude of the types of activities they're engaging in, or have engaged in for the past 2 years.

Mr. BOEHLERT. Thank you. No further questions.

Mr. BEDELL. Mr. Schaefer.

Mr. SCHAEFER. No questions.

Mr. BEDELL. Mr. Modell, I understand that you have some knowledge of the return on the Trans-Alaska Pipeline. Is that correct?

Mr. MODELL. Mr. Chairman, in December 1982 Mr. Blum testified for the committee, and we presented figures that the pipeline actually cost about $9.4 billion to construct.

Based on the tariff figures, which the owners of the pipeline, including Arco and the others are using, and the utilization rates, we understand that they were recovering about $3½ billion per year, which means the cost of the Trans-Alaska Pipeline could be recovered in a matter of 4 or 5 years, even though it's intended to last for about 40 years.

On the issue of those tariffs, the tariffs are legal due to inaction by another Government agency, namely, FERC. The tariffs that have been used by the owners of the pipeline, the tariffs which they filed, and they set, the Federal Energy Regulatory Commission has had a proceeding going on now for 6 years where it's supposed to be setting those tariffs.

In 1977 the Interstate Commerce Commission, before FERC was created, came out with a decision that said the just and reasonable tariff should be in the range of about $4.68 to $5.10 per barrel. Those rates remained in effect for about 7 months until FERC was created by the Department of Energy Organization Act, at which point the owners were able to go back legally to the rates they filed, which in the case of Arco, for example, is $6.04 a barrel.

As I understand it, a tentative decision came out from an administrative law judge at FERC for years 1978 and 1979 that would have forced the owners to reduce their tariffs had that been adopted by FERC. There's been no final action at that agency to date. I think a few companies like Exxon, and BP, have voluntarily reduced their own tariffs to the area of the rates suggested by the administrative law judge. I don't believe Arco or a number of the others have done that.

Mr. BEDELL. I thought there might be a little interest in this.

I'll yield to Mr. Sisisky first.

Mr. SISISKY. The pipeline is owned by Arco and two other companies; am I correct in that?

Mr. MODELL. As I understand it, there are eight owners of the pipeline.

Mr. SISISKY. Eight owners.

Mr. MODELL. Yes.

Mr. CHISHOLM. I think, Mr. Sisisky, that the 90 percent of the pipeline is owned by three companies.

Mr. SISISKY. I remember reading something about that.

Mr. CHISHOLM. It's very small. Very small what the other companies own.

Mr. SISISKY. Now, the amount of money that they're charging in there actually has an impact on the windfall profits; am I correct?

Mr. CHISHOLM. That's correct.

Mr. SISISKY. The American consumer is paying that charge of rates that FERC, forget about the tax now. We're just talking about the transportation rates; that pipeline will pay itself off every 4 years on a full year's supply of oil?

Mr. MODELL. I'm not sure the consumer is paying those rates directly, and because by charging themselves these rates, there's a reduction in the removal price of the crude oil. I'm not sure the company is actually transferring the money. It's probably a book transfer.

But for every dollar they charge themselves for the pipeline tariff, it's 70 cents in lost revenue under the windfall profits tax.

Mr. BEDELL. Mr. Bilirakis?

Mr. BILIRAKIS. I guess I just want to go into another facet of it, rather than to continue on a very good point made by Congressman Sisisky.

The predecessor of FERC is the Federal Power Commission. Now, are you saying that there has not been any continuity, any stability in the decisions made by the Federal Power Commission, and they have not been accepted, and just continued on by FERC? I understood you to basically say that.

Mr. MODELL. Mr. Bilirakis, as I understand it, the predecessor in terms of the Trans-Alaska Pipeline regulation was the ICC, not the Federal Power Commission in terms of rate setting for the tariffs.

The ICC set some rates for TAPS in 1977 as to what would be just and reasonable rates. When the statutory authority to set rates for TAPS was transferred to FERC with its creation in 1977, the DOE Organization Act, the ICC decision fell by the wayside, and they went back to the owner's own filed rates in terms of what they'd been using all these years.

FERC has had authority since 1977 or 1978, has done nothing to set final rates, even going back to 1978. There have been tentative decisions issued, recommendations from the administrative law judges, but FERC has not issued a final action. In fact, they've most recently remanded the whole proceeding back to the administrative law judge once again to decide whether the methodology they've used in other rate cases should apply to Trans-Alaska Pipeline. They haven't even established that.

Mr BILIRAKIS. Is it a fact then that the ICC did establish the original tariff?

Mr. MODELL. I have a citation to an ICC decision in 1977 where they set the just and reasonable tariff substantially below the tariffs filed by the owners.

Mr. BILIRAKIS. Thank you. Thank you, Mr. Chairman.

Mr. SISISKY. Would the gentleman yield just for one more moment?

Mr. BEDELL. Surely.

Mr. SISISKY. I would suggest, Mr. Chairman, because this has an impact on the tax that perhaps we have a meeting, and have staff draw up a letter, and meet with FERC to find out what is happening there. That has an impact not only with the one company mentioned, but the other companies too, as far as tax revenue is concerned.

Mr. BEDELL. But do I understand you correctly that your understanding is that the different oil companies are charging different rates as oil is transported through that same pipeline, the same oil, in effect?

Mr. MODELL. Yes, Mr. Chairman, and I think that is permissable under the law, depending upon their investment in the pipeline; determination of a just and reasonable return for them. They have set different rates.

As I mentioned, I think that Exxon and BP have reduced their rates as a result of the administrative law judge tentative decision. They voluntarily complied, but I don't think Arco has taken that type of action.

Mr. BEDELL. Mr. Sisisky has recommended that at the minimum, we at least have a meeting with FERC, if not a hearing to discuss this issue with them. Is that the will of the committee?

The staff will be directed to try to arrange such a meeting.

I think your testimony has been most helpful to us, and we appreciate it very, very much. Thank you.

[See app. C.]

Mr. BEDELL. Our next panel consists of Harry Langdon, executive vice president of Tosco Corp., and Timothy Columbus, from the Society of Independent Gasoline Marketers of America.

We are, as is frequently the case, running short of time, so we would sure appreciate it if you would summarize your testimony as much as you possibly can. We want to be sure that we have some

time to talk with the people who are here from the major oil companies.

Mr. Langdon, we will ask you to go first.

PANEL CONSISTING OF HARRY L. LANGDON AND R. TIMOTHY COLUMBUS

TESTIMONY OF HARRY L. LANGDON, EXECUTIVE VICE PRESIDENT, TOSCO CORP.

Mr. LANGDON. My name is Harry Langdon. I am executive vice president of Tosco Corp., and I have responsibility for the company's refining and marketing operations.

I would like to thank Chairman Bedell for the opportunity to appear, and I want to commend the chairman for his interest in this important matter.

I would first like to mention some important points about Tosco before we go on with other matters. Tosco does not own significant crude oil reserves. We sell all of our products to independent marketers. We own no service stations so therefore we are not competing with our customers.

Almost all of our crude is brought from third parties. We are the largest independent refiner on the west coast, and one of the largest in the United States.

We are also one of the largest purchasers in arms-length transactions of Alaskan North Slope crude on the west coast. Our west coast refineries are among the most sophisticated according to survey publications which rate refinery complexity.

Although Tosco is a refining company, and Mr. Columbus represents the marketers, some of whom are our customers, we share, I think, our concerns about the plight of the independent sector of the petroleum business.

In addition to the tax revenue impact to the U.S. Treasury surrounding the windfall profit tax issue, there is another very fundamental factor that is affecting the marketplace for west coast independent refiners, and thus for the independent marketers who rely on their source of supply from these refiners.

That factor is that at least one ANS producer is, to the best of our understanding, currently charging its west coast refining operations a transfer price of North Slope crude of about $2.50 a barrel below the price at which that Tosco can buy in arms-length transaction from suppliers.

This producer is Arco. Tosco doesn't mean to point only to Arco, but we have more public information about its ANS pricing policies than some of the other producers.

We have tried to buy ANS crude for this nominal $24.50 Arco transfer price, and we cannot. This $2.50-a-barrel, or over 5-cent-a-gallon unfair crude oil advantage is absolutely huge in comparison to the average profits for the refining industry.

For example, Exxon's annual report shows that its refining profits in the last few years average about 2 cents a gallon.

Arco, even with this transfer price advantage I have been mentioned, has had a profit of about 4 to 7 cents a gallon in the same time period. Many independent refiners who do not own their own crude supply, and have to buy from others at arms-length transac-

tions, in the long term, will not be able to compete with this nominal 5-cent-a-gallon crude oil price disadvantage which is derived from this ANS windfall profit tax issue.

Tosco should be in a better position to survive than many of the other refiners because of its sophisticated refinery hardware. Tosco has been in a massive cost reduction program to help ease this burden. But, frankly, there just are not enough things to eliminate in order to compensate for this nominal 5-cent-a-gallon advantage I discussed regarding Arco.

Our customers are aware of the cost disadvantage suffered by the west coast independent refiners, and they are worried about their long-term security of gasoline supplies. Some of them have switched to certain majors in order to hedge their bets in this very volatile marketplace that we find ourselves in.

Majors have increased their market share in the last year or so at the expense of the independents. As an example, Arco has increased its share. In January 1982, it had about 9.25 percent of the gasoline market share in PADD-V, and by December 1982, that had increased to about a 13.25 percent market share.

Tosco intends to survive and will do everything it can reasonably do to be the low-cost producer of petroleum products so that we can serve the independent gasoline marketplace on the west coast.

This crude transfer price advantage we talked about is absolutely overwhelming, to say the least. So, in summary, we urge you and the Treasury Department with the IRS to promptly resolve this ANS windfall profit tax issue so that, as independent refiners and marketers, especially on the west coast, we will be able to compete fairly.

Thank you for this opportunity to speak before the committee.

Mr. BEDELL. Thank you very much, Mr. Langdon.

[Mr. Langdon's prepared statement follows:]

PREPARED STATEMENT OF HARRY L. LANGDON, EXECUTIVE VICE PRESIDENT, TOSCO CORP.

My name is Harry L. Langdon. I am Executive Vice President of Tosco Corporation, and I have responsibility for Tosco's petroleum refining and marketing operations. On behalf of Tosco, I want to thank you for this opportunity to express Tosco's views and concerns regarding the administration of the Windfall Profit Tax with respect to Alaska North Slope crude oil.

I would like to commend Chairman Bedell for his interest in this important issue, which vitally affects independent refiners and marketers of petroleum products. We are also aware that Mr. Bedell, in his prior capacity as Chairman of the Energy Subcommittee of this Committee, established a substantial record on the important competitive role of independent refiners.

As this Committee is aware, the importance of the administration of the Windfall Profit Tax on Alaskan crude oil goes beyond the need to collect the revenues which are properly due to the Treasury. In the case of integrated companies which refine their own ANS crude, calculation of the "removal price" on which the tax is based significantly affects the amount of tax. This tax calculation has a major influence on the raw material costs of integrated companies. The government's current administration of the tax gives integrated oil companies the latitude to calculate an artificially low internal removal price. This creates a substantial subsidy at the expense of the Treasury; and for independent refiners, who must purchase ANS crude oil at real market prices bearing the full Windfall Profit Tax, the result is an inequitable competitive burden.

My statement points out the impact of these inequities and urges that administration of the tax be quickly remedied to require all tax calculations to be based on real market conditions, before the adverse impacts on the independent refining and marketing sectors become irreversible.

INDUSTRY BACKGROUND

To provide a perspective on the current situation, recall the interplay between majors and independents after the Arab Embargo in 1973 and during those years when demand outstripped supply. The majors attempted to reduce gasoline supplies to the unbranded independents and withdraw from remote markets. They preferentially supplied their own company-operated and branded dealer stations and consolidated their sales into the large metropolitan markets close to the refining centers where profitability was the highest. Today, in sharp contrast, there is plenty of supply and the opposite is happening. The major refiners are becoming extremely aggressive in expanding markets at the expense of the independent sector.

The independent refining and marketing sector of the petroleum industry provides a valuable service to the industry and the community at large. It offers a choice: it has traditionally supplied products to all markets at lower prices; it is an essential part of the complex and delicate petroleum refining distribution system which assures that all consumers receive products; and it assures a competitive market. Without an independent refining sector, marketers would have only one choice: market gasoline produced by a major, with the probability of strong pressure to sell on a branded basis, or go out of business. Either way, the nation would lose the efficiencies and flexibility which are provided by the independent sector and which assure that all markets are adequately and competitively served.

THE NATURE OF TOSCO'S BUSINESS

Tosco is engaged in the refining and wholesale marketing of petroleum products. We own four petroleum refineries located in California, Oklahoma, and Arkansas, with an aggregate refining capacity of approximately 261,500 barrels per day and related wholesale distribution facilities.

Since Tosco does not own significant crude petroleum reserves, substantially all of our crude oil requirements are supplied by unaffiliated parties, principally from domestic sources including Alaska. Tosco is one of the largest non-producer purchasers of Alaska North Slope crude oil on the West Coast.

We sell unbranded refined petroleum products to wholesale purchasers, and substantially all of these sales are to independent marketers who compete with major oil company retail networks as well as other independent marketers. Tosco has no retail outlets, and sells gasoline to our wholesale customers at rack price.

Tosco is one of the largest independent gasoline refiners in the United States and the largest independent refiner on the West Coast. Our two West Coast refineries, at Avon and Bakersfield, California, are equipped with sophisticated conversion equipment such as coking, catalytic cracking and hydrocracking units. According to standard, industry-wide measures, these two facilities are ranked among the most complex refineries located on the West Coast. These highly complex refineries are capable of processing lower-grade and less costly crude oils to produce higher ratios of the premium, higher-priced products than can be produced by most competing refiners, including majors with comparably priced crude oil.

THE WEST COAST MARKETPLACE

The West Coast marketplace in which Tosco and its customers operate has been one of intense competition and increased consumer sensitivity to prices since early 1982. During this period, the normal competitive pressures which are inherent in the marketplace have been compounded by aggressive marketing practices by the integrated majors. We point specifically to Atlantic Richfield Company in this statement, in part because it has disclosed more about its practices than other operators, but the same practices could be utilized by any integrated company producing ANS crude oil.

ARCO has substantially increased its market share by cutting sales prices. For example, an examination of Lundberg reports of earlier this year suggests that an unusually high percentage of ARCO's retail stations in Los Angeles had retail pump prices less than those of neighboring independent stations. When these pump prices are adjusted to derive ARCO's net price at the refinery, the resulting price is well below the product production cost of Tosco and, presumably, most other refiners. Since Tosco's California refineries are among the most complex refineries on the West Coast, other refiners must also have been subject to brutal economics.

Tosco cannot criticize any company for achieving efficiency or for the effective use of a legitimate competitive strategy. We are concerned, however, that the ability to offer prices well below those of competitors, at least in selected markets, may reflect factors other than efficiencies. Indeed, it appears that ARCO's low product prices

may be based, in large measure, on tax-subsidized crude oil costs, which are a function of the methodology which the company has followed in computing its Windfall Profit Tax liability for ANS crude oil. In particular, its transfer price to its West Coast refineries is about $2.50 below the market price which Tosco must pay.

For Alaska North Slope crude oil, ARCO has been using a methodology for determining its "removal price," on which its Windfall Profit Tax liability depends, which is fundamentally different from that of the other producers. Two of the other ANS producers have testified that, to derive the removal price for oil delivered on the West Coast, they back out actual transportation costs from the West Coast market value of ANS crude; and, to derive the removal price for Gulf Coast deliveries, they back out actual transportation costs from the Gulf Coast market value of ANS crude.

ARCO, on the other hand, has said that it calculates the removal price for all its internally processed ANS crude by referring to the price of West Texas Sour crude on the Gulf Coast. Then it deducts the hypothetical cost of transportation from the Alaskan North Slope to the Gulf Coast, ignoring the West Coast market, despite the fact that ARCO refines more than 75 percent of its ANS production on the West Coast. ARCO thus reduces its removal price and its tax burden substantially.

Independent refiners purchasing ANS crude cannot avail themselves of the advantages offered by this unrealistic tax methodology. A hypothetical but realistic Congressional analysis indicates that this difference in methodology has resulted in Windfall Profit Tax savings of more than $2.00 per barrel for ARCO, which refines more than 270,000 barrels per day of ANS crude on the West Coast.[1] This disparity in tax calculations translates to a price differential of about a nickel a gallon on refined petroleum products.

The narrow margins recently experienced by refiners mean that companies which use this methodology can put their competitors at a serious disadvantage. The fact that margins are extremely tight is further illustrated by recent refiner net income figures for petroleum product sales. For example, in the past three years Exxon has reported a net income per gallon for its refining and marketing operations of about two cents, and ARCO's own refining and marketing net income has ranged from four to seven cents per gallon.

For independent refiners such as Tosco, which cannot normally buy ANS crude oil at the low price used by ARCO and others who use similar methods, the impact of Windfall Profit Tax calculations based on hypothetical transportation costs is devastating, and makes competing with companies that use this methodology extremely difficult.

Since April of 1982, Tosco has experienced a substantial drop in gasoline sold in the West Coast markets. More significant is that during this same period Tosco has from time to time been forced to sell product at an operating loss to meet the lower prices of certain majors.

The impact of a nominal five-cent-a-gallon tax advantage upon independent refiners is such that, no matter how efficient an independent refiner becomes, it cannot compete with an integrated company which uses such tax treatment. This advantage, which in essence has been subsidized by the United States taxpayer, is enough to cause severe problems for the independent sector. If the tax benefit is further prolonged, it will result in irreparable damage to the competitive structure of the industry. Cost reduction programs of almost any magnitude cannot mitigate the impact of the subsidized advantage.

Data available now suggest that the impact of the advantage already has been substantial. In PADD–V, for example, according to Lundberg Surveys, the percentage split of gasoline market share between the majors and independents went from 74.39 (majors) versus 25.61 (independents) in January 1982, to 77.61 (majors) and 22.39 (independents) in December 1982. This represents an increase in market share of more than 4 percent for the majors, and a decrease in market share of more than 12 percent for the independents. During that same period, ARCO's market share in PADD–V increased from 9.25 to 13.36 percent. This downward trend in the aggregate market share held by independents is mirrored by the significant number of independent retailers who were forced out of business during the past year, or who were in sufficient economic distress that they shifted to become major brand dealers. Tosco has recently seen major unbranded jobber accounts, which traditionally have been independents, switch to become major brand distributors.

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[1] John D. Dingell, "Briefing Memorandum for February 23rd Hearing," to House Energy and Commerce Subcommittee on Oversight and Investigations (February 16, 1983).

THE NEED FOR ACTION

In light of these serious competitive problems, the Treasury and the Internal Revenue Service should move promptly to clarify the methodology by which an integrated refiner must calculate its removal price for the ANS crude oil which it refines. Failure to take prompt and effective action could result in further irreparable harm to independent refiners who do not have their own crude oil supplies, with serious adverse long-term consequences for independent retailers and consumers.

Revenue Ruling 83-124, which was issued last month by the IRS, is a step in the right direction because it clarifies the intended application of principles established by Section 613 of the Internal Revenue Code in determining the removal price for Windfall Profit Tax purposes. As Tosco understands the application of these principles, a producer would not be allowed to use conditions and prices prevailing in the Gulf Coast in determining the value of its ANS oil refined internally on the West Coast.

It is essential that the Windfall Profit Tax be calculated in a manner which reflects the true market conditions on the West Coast, and the prices paid by independent refiners such as Tosco. Because the ruling does not specifically preclude reference to prices in a separate market, ANS producers may continue to calculate the removal prices for oil delivered on the West Coast.

Thus, it appears that Ruling 83-124 has not provided sufficient guidance to correct the current competitive inequity, and that further guidance and clarification is urgently needed. It may be that differing circumstances make it difficult to prescribe a single reference price or a single method of calculation. However, it defies common sense to think that Congress intended to allow widely differing methodologies to be used by integrated producers over an extended period of time in a manner which threatens the competitive survival of independent refiners. Unless the Treasury and IRS can move promptly at a minimum to prevent the use of hypothetical and artificial market conditions as a basis for the tax on West Coast deliveries, Congressional intervention and clarification may be necessary.

Mr. BEDELL. Mr. Columbus.

Mr. COLUMBUS. Thank you, Mr. Chairman.

TESTIMONY OF R. TIMOTHY COLUMBUS, ON BEHALF OF THE SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA

Mr. COLUMBUS. My name is Tim Columbus. I am a member of the law firm of Collier, Shannon, Rill, and Scott. I appear today on behalf of our client, the Society of Independent Gasoline Marketers of America.

SIGMA is a national trade association of independent marketers and private brand chain retailers, whose members operate throughout 49 of the 50 States and who represent a significant share of the retail market for gasoline. SIGMA's interest in this particular issue really arose when many of its members, operating in markets in which the Atlantic Richfield Co., had historically very large operations of its own, found that their marketing efficiencies were basically being rendered irrelevant.

Specifically, independent marketers found that they were unable to obtain at the wholesale level gasoline at a price which permitted them to meet the retail price being charged by Arco through its branded system.

Since this situation developed, SIGMA's members have lost substantial market share and are in the process of watching their historic and basically secure sources of independent supply withdraw from the market.

SIGMA has tentatively concluded that the ability of Arco to operate at the price level at which it appears to operate derives effectively from its method of computing its windfall profits tax liability on Alaskan North Slope crude oil which it delivers to the west coast.

Specifically, it is our understanding that Arco computes the removal price of that crude oil by subtracting from the west Texas sour crude oil price on the gulf coast transportation back to the wellhead.

Now, that should result, based on what we have heard from other companies, in a west coast transfer price to Arco's refineries significantly less than the market value of crude oil on the west coast.

Exxon, and Sohio, the two other principal producers on the North Slope, have testified that they employ a substantially different method. Specifically, with request to crude oil produced on the North Slope of Alaska and delivered on the west coast by Exxon and calculate the removal price for that crude oil based on west coast market prices; that is, they do not reference the gulf coast price for west Texas sour.

It appears to us that Arco's method generates a substantial cost saving for it. Specifically, in sworn testimony before Congressman Dingell's Subcommittee on Oversight and Investigations, Exxon and Sohio both testified that the price differential for a barrel of a particular grade of crude oil, between the west coast price and the gulf coast price is approximately one dollar. Let me just pull a number out of the air so I don't lose you with my example. Let us say that a barrel of Alaskan North Slope crude oil on the west coast might be priced at $30. That same barrel would sell in the gulf coast market for approximately $31.

Now, the rub comes in with the fact that the waterborne transportation costs of moving that barrel of crude oil from the west coast to the gulf coast would be much more, in the neighborhood of $3 per barrel. Thus, by referencing a gulf coast price and subtracting transportation back to the wellhead, Arco appears to engender for itself a substantial cost savings vis-a-vis the Tax Code.

Now, Sigma, along with others had urged members of this subcommittee and other Members of Congress to seek a prompt and definitive administrative resolution of this issue. It appears to us that on August 8, the IRS attempted to come up with that sort of solution in ruling 83–124.

It is our conclusion that ruling does not constitute the sort of prompt and definitive resolution of this issue for which we had hoped.

Basically, ruling 83–124 states only that an ANS producer must employ the principles of 613 of the code in determining its removal price, for example, it must look to a representative market price. However, the ruling stops short of identifying the representative market of Alaskan North Slope, if you will. Therefore, the ruling effectively leaves the issue open and unresolved. The ruling may, in fact, constitute a road map for auditors to resolve this problem. However, it does not result in a resolution of this problem in a timely fashion.

As you have heard from other people today, it is our anticipation that should the service decide to resolve this issue in the context of audit, we are looking at literally years and years of litigation.

In the meantime, people represented by SIGMA find themselves in an untenable position, in the context of a competitive marketplace where they frequently cannot obtain product at a price which

equals much less lets them beat the retail price charged to parts of the Arco-branded system. We would urge this committee to go forward and continue pressing the administration for some sort of prompt resolution, and if that resolution is not forthcoming, to make recommendations to the House Ways and Means Committee regarding a legislative solution.

On behalf of Sigma, I would like to express our appreciation and respect for the members of this committee's interest in this matter. We believe it is, in fact, a matter of interest not only to us but to the U.S. Treasury, and we sincerely hope that you get on with the business that we have laid before you.

Thank you. I would be happy to respond to any questions that my testimony may have raised.

[Mr. Columbus' prepared statement follows:]

PREPARED STATEMENT OF R. TIMOTHY COLUMBUS, ON BEHALF OF THE SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA

My name is R. Timothy Columbus and I am a member of the law firm of Collier, Shannon, Rill & Scott. I appear today on behalf of our client, the Society of Independent Gasoline Marketers of America ("SIGMA"). SIGMA is a trade association comprised of approximately 240 independent marketers and private brand chain retailers of motor fuels. SIGMA's members market in 49 of the 50 states and their sales represent approximately 10 to 15 percent of domestic retail motor fuels sales.

SIGMA members historically have been recognized as among the most efficient and innovative retailers of motor fuels. They innovated such concepts as high volume/low margin retail operations and self service. Their ability to minimize their fixed overhead, i.e., the amount of costs which must be recovered in each unit sold, has enabled them historically to deliver motor fuels to consumers at prices substantially below the prices offered by their branded competitors. In sum, SIGMA's members built their businesses, based on superior functional efficiency. Absent the intervention in the market of factors not related to the function of retailing, their efficiency should ensure the economic viability of the companies which SIGMA represents.

SIGMA's intense interest in the matter under consideration by the Subcommittee today originated when a significant number of its members found themselves unable to obtain motor fuels on the wholesale market at prices which would permit them to compete at retail with prices being offered by the Atlantic Richfield Company's ("Arco") dealers. Specifically, SIGMA members reported that they were unable to obtain product on the wholesale market at prices equal to, much less lower than, the prices being offered in the Arco retail system. When Arco subsequently reported substantial profits in the context of this pricing program, SIGMA's members concluded that economics suggested that Arco had a cost advantage not previously recognized, which apparently was unavailable to other market participants, and which it was employing to support its new marketing program. As SIGMA has indicated previously before this Subcommittee, it has concluded, based upon the information available to it, that Arco's method of computing the removal price of its Alaskan North Slope crude oil ("ANS") for purposes of the Windfall Profit Tax generates a significant cost savings for Arco. It appears to SIGMA that Arco has employed this tax savings to underwrite its marketing program at the expense of its competitors and the United States Treasury.

The public statements of Arco and the two other principal producers of ANS, Exxon Corporation ("Exxon") and The Standard Oil Company (Ohio) ("Sohio"), confirm that Arco employs a methodology for computing the removal price of its ANS which differs significantly from that employed by Sohio and Exxon. Moreover, it appears that Arco's methodology generates for it a cost savings of sufficient magnitude to explain its apparent ability to market motor fuels at price levels substantially below market while remaining profitable. Because SIGMA perceives this methodology as affording Arco an unintended and inequitable cost advantage, it has urged Members of Congress to seek a prompt administrative resolution of the ambiguity regarding the proper method by which to compute the removal price for ANS. Revenue Ruling 83-124 apparently constitutes the Internal Revenue Service's ("IRS") attempt to resolve this matter. However, rather than resolving this matter, the

Ruling, because of its Delphic nature, results in continuing uncertainty which emphasizes the need for a prompt, definitive resolution of this dispute.

Simply summarized, the Ruling confirms SIGMA's conclusion that the removal price of ANS must be determined in accordance with the principles of Section 613 of the Internal Revenue Code ("I.R.C."), i.e., the price of ANS should be determined with respect to the price of crude oil in the nearest representative market. However, the Ruling does not resolve the controversy because it does not clearly establish the identity of the nearest representative market for ANS. Thus, the administrative resolution of this matter sought by many Members of Congress, including the Chairman of this Subcommittee, has not been forthcoming.

Arco asserts that the representative market for ANS crude oil should be recognized as the Gulf Coast market for West Texas sour crude oil. In contrast, Exxon and Sohio, at least with respect to those volumes of ANS which they deliver on the West Coast, have based their removal price for ANS on West Coast market prices. In short, it appears that Exxon and Sohio have recognized, and in SIGMA's view properly, that at least with respect to ANS delivered on the West Coast, the representative market for pricing that crude oil with respect to the Windfall Profit Tax is the West Coast market. It is this conflict, i.e., whether the representative market for the purposes of computing the removal price of ANS delivered on the West Coast is a West Coast market price or a price in the distant and unrelated Gulf Coast, that the Ruling fails to resolve definitively. As a result, the impact of the Ruling, at least for the foreseeable future, on competition in the gasoline market will be minimal, if any.

SIGMA believes that prompt action to resolve the ambiguity and uncertainty left by the Ruling is essential. Section 613 of the I.R.C., and the principles developed in the case law interpreting it and its predecessors, reflect the desire that for the purposes of collecting taxes, the removal prices for a commodity reflect its fair market value at its point of production. Arco asserts that its methodology achieves this objective. It appears to SIGMA that Arco's methodology does not, in fact, achieve that objective.

Arco has confirmed that the majority of its ANS is delivered to the West Coast. From Arco's statements, it appears that Arco determines the removal price of ANS delivered on the West Coast by deducting, from the Gulf Coast price of West Texas sour, an amount which it states represents the transportation between the actual point of delivery and the Gulf Coast. This method of imputing a price for its ANS appears to understate dramatically the value of that crude oil on the West Coast. Specifically, Arco's method appears to be premised upon the assumption that the price differential between West Coast markets and the Gulf Coast reflect only transportation costs, i.e., the price of ANS in Southern California will differ from the Gulf Coast price by an amount equal to the cost of transporting that crude oil between these points. However, the facts appear to contradict the validity of Arco's underlying premise.

In sworn testimony before the Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee, Exxon and Sohio both effectively indicated that Arco's apparent assumption regarding the relationship between crude oil's value on the West Coast and Gulf Coast does not reflect reality. Specifically, Exxon and Sohio both stated that the price differential between these two markets was approximately $1.00 per barrel.[1] However, the cost of transporting crude oil from the West Coast to the Gulf Coast was much greater than $1.00 per barrel.[2] Thus, employment of Arco's methodology results in a substantial understatement of the value of its ANS on the West Coast and a corresponding undervaluation of that crude oil at the wellhead.

The ultimate test of any method of imputing the market value of a commodity is whether a willing buyer can obtain the commodity in the market at the imputed price. SIGMA's members have been advised by independent refiners from whom they historically obtained supply that such refiners are unable to obtain crude oil comparable to ANS in the West Coast market at prices equal to those which would be derived from Arco's methodology. If this information is correct, then Arco's methodology clearly fails the ultimate test of an imputation method's validity, and prompt action is necessary to correct that situation.

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[1] The Windfall Profits Tax and Product Marketing Consequences of the Wellhead Pricing Practices of Alaska North Slope Crude Oil Producers: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 98th Cong., 1st Sess. 21 (1983) (testimony of Robert J. Doyle, Vice President, Exxon Co., U.S.A.).

[2] *Id.*

It was SIGMA's hope that IRS would take prompt, definitive action to eliminate the ambiguity and confusion which has generated this dispute. The Ruling does not constitute the definitive resolution of this matter for which SIGMA had hoped. Thus, SIGMA is forced to conclude that the Service has decided to resolve this matter in the context of the audit process. Such a decision is unacceptable because it means literally years of continued uncertainty. If SIGMA's analysis is correct that Arco's methodology is improper, then irreparable damage will be done to the structure of competition pending the Service's resolution of this issue. Thus, it appears that Congress itself must act to address and resolve this matter.

In summary, Arco has adopted and employs a method for computing the removal price of its ANS which (1) appears to be premised on a faulty assumption regarding the relationship between the West Coast and Gulf Coast markets, and (2) appears to provide it with a substantial competitive advantage in the gasoline marketplace. Both logic and clear Congressional intent indicate that this result is improper. As the Supreme Court stated in the context of another dispute related to the construction of a depletion allowance, "Respondent's formula would not only give it a preference over the ordinary nonintegrated miner, but also would grant it a decided competitive advantage over its nonintegrated manufacturer competitor. Congress never intended that depletion create such a discriminatory situation. As we see it, the miner-manufacturer is but selling to himself the crude mineral that he mines, insofar as the depletion allowance is concerned." *U.S.* v. *Cannelton Sewer Pipe Company,* 364 U.S. 76, 87 (1960). It appears that Arco's methodology creates precisely the situation decried by the Supreme Court. Congress must act promptly to eliminate any ambiguity in this area. Absent such prompt action, both the structure of competition in the gasoline market and the Treasury will suffer.

SIGMA sincerely appreciates this opportunity to express its views on this matter.

Mr. BEDELL. Thank you very much.

Mr. Sisisky.

Mr. SISISKY. Your last statement, of course, is the one that is the emphatic statement and a key to this whole issue. It seems to me that if we foot drag, and the Internal Revenue Service foot drags, then obviously the signwavers now would allow the footdragging, because you are not constrained by the statute of limitations, then your membership is really in peril of going out of business.

Mr. COLUMBUS. They, sir——

Mr. SISISKY. We could drag this thing on for years, and that doesn't solve the problem if, indeed, they are using the advantage of saving money from taxes that they should have been paying, or certain of them should have been, then your membership, the small gasoline marketing people and the small refineries too are in jeopardy, and as long as this thing can be delayed, the more chaos we can have in that industry.

I'll just finish this statement; in my opinion, it is to the public interest that the small gasoline retailers and refiners do not go out of business, even though the public may benefit, Mr. Chairman, on the short-term basis by reduced prices. In the long term, they will suffer, as the competition.

So, of course, I was making a statement rather than a question, but that is correct, what I am saying about the extending out the time period.

Mr. COLUMBUS. Absolutely, Congressman.

Our members have viewed with great alarm what appears to be a significant restructuring of the competitive structure of the market, particularly on the west coast and the Middle Atlantic States on this end of the country. It is true. Some of our members are among the companies previously mentioned, who have gone, picked up major brand identification, something they had historically not done.

A matter of great alarm to us is the effect of some on the independent refining segment. Very simply, if independent refiners are driven from the marketplace, the costs of reentry at that level, that is, the costs of coming into being for a potential source of supply for our members, are overwhelming. And I might add, the whole idea of using a formula to determine removal price ought to be judged against one ultimate test, and that is: Does it reflect a fair market value of the commodity?

I don't care if you start with the gulf coast or the west coast, your accountant can prove anything to you. But what you ought to find out is can a willing buyer go into the marketplace and obtain the commodity which you are trying to value at the price which you attribute as its value.

Tosco's testimony and the comments of other independent refiners to whom our members have talked suggest that they cannot obtain crude oil at the price which Arco appears to be transferring into its west coast refiners, and that is a real problem and it has very long-range implications.

Mr. SISISKY. One more question.

Mr. Langdon, I was delighted to hear you say about your refinery's being the most modern, up-to-date refineries. I don't think it is the purpose of this committee or the U.S. Congress to interfere in the competitiveness of a business when someone is in better shape to do it, but are you an exception as a small refiner, being able to compete with new modern equipment? Is Tosco an exception in that market or not?

Mr. LANGDON. We may be one of the exceptions to be able to compete with Arco, because we have invested rather substantially. We just finished a project costing more than $160 million at our San Francisco refinery, which makes it one of the best refineries on the west coast and able to handle a whole variety of crudes in a very complex way.

I think some of the other independent refiners are going to be more in jeopardy, but if some of them are not there, then the supply alternatives for the independent marketers are reduced, and that puts them in more of a bind than they would be otherwise. I think that, without the independent marketers, there are no independent refiners, and you have got to have some reasonable mix of the two to keep supply alternatives available.

Mr. BEDELL. Mr. Bilirakis.

Mr. BILIRAKIS. So, Mr. Langdon, you do not attribute any portion, or any substantial portion to the difference in profits that Arco is receiving versus your company, as a result of the efficiency of their equipment? You are saying that your refineries are just as efficient as theirs?

Mr. LANGDON. With the modernization we just put in, we are.

Mr. BILIRAKIS. You have just put in?

Mr. LANGDON. Likely to be, I can't prove it because I don't know their operating costs in detail.

Mr. BILIRAKIS. Sir, do you know approximately what the production from the Alaskan North Slope was last year, let's say, the Arco production was, on a barrels-per-day basis?

Mr. LANGDON. Oh, there was around 350,000 barrels a day of production.

Mr. BILIRAKIS. Do you know the production of Exxon and Sohio?

Mr. LANGDON. Exxon is about the same, and Sohio is probably about twice that much.

Mr. BILIRAKIS. About twice that much? So, we would say, then, that Arco is approximately 300,000 barrels per day, and Exxon and Sohio combined, approximately 900,000 barrels per day?

Mr. LANGDON. Well, it is a little more than that, the combination of the three.

Mr. BILIRAKIS. Approximately.

In your opinion, Mr. Columbus, I guess I'll ask you being the attorney, and we attorneys usually catch the more difficult——

Mr. COLUMBUS. Congressman, you have proved it can be overcome.

Mr. BILIRAKIS. Why are Exxon and Sohio not using the same methodology for windfall profits tax that Arco is using?

Mr. COLUMBUS. It is always dangerous to inhabit the mind of somebody else.

Mr. BILIRAKIS. Yes.

Mr. COLUMBUS. I would assume, given the fact that Exxon has testified that had it used Arco's method, it would have saved itself approximately $50 million in windfall profits tax payments in 1982, but they had reached the conclusion that that methodology is not one that they want to live with when it comes to the test of time and the IRS.

I assume they think that they can't use it. Exxon is not a well-known volunteer taxpayer. [Laughter.]

I think there are people from the Treasury in the back of the room who will bear that out.

Mr. BOEHLERT. Do you have a list of those who are?

Mr. COLUMBUS. And to the—— [Laughter.]

Congressman, I promise you, I will not appear on it either, but it seems to me that if they thought the methodology were valid, they would certainly employ it and take advantage of the tax savings that it would generate for them.

Mr. BRITT. Will the gentleman yield?

Mr. BILIRAKIS. I would be happy to yield.

Mr. BRITT. What rationale has Arco put forward to justify basing it on gulf coast versus the west coast?

Mr. COLUMBUS. Again, and you will have the opportunity to ask them that question. I can only take what I have heard from their public statements. It is my understanding that—they take a look at section 613 which says you look to the representative market for the price.

They have determined that they believe the west Texas sour market, at the gulf coast, is the representative market, and from that market price, they would subtract out the cost of transporting crude oil to that point.

That is my understanding of their rationale. I personally would dispute that, simply because I believe the gulf coast market is a very different market than is the west coast market. As the price differential of $1 as opposed to the $3 which would reflect the transportation price differential suggests, prices in the gulf coast market reflect primarily a great deal of indigenous crude oil in addition to Mexican, Venezuelan, West African, and North Sea crude

oil. Those are not the factors which basically drive the west coast market for crude oil, and I am sure Mr. Langdon can speak to that with greater authority than I.

Mr. BILIRAKIS. It is interesting to me, Mr. Chairman, that with the greater production Exxon and Sohio, at least Sohio with the double amount of production, that they have apparently chosen to use another method. What a gamble on their part if it is determined that the Arco method, in fact, is what was intended by the writers of that legislation.

I have no further questions.

Mr. BEDELL. Mr. Ray.

Mr. RAY. No questions.

Mr. BEDELL. Mr. Britt.

Mr. BRITT. Mr. Langdon, you have mentioned the inability to purchase crude in the open market at prices similar to what Arco charges themselves. Would you just flesh that out a little bit the transfer price, and what that causes in terms of problems to you and competition in general?

Mr. LANGDON. Well, we look at our cost of crude and our cost of refining the product in order to try to set market prices, but that is also affected by what the competition is doing, and when Arco has an advantage from an internal pricing point of view upwards of a nickel or so a gallon, that gives them greater latitude to start with a lower raw material cost and add on whatever efficiencies they have in refining. They can become much more aggressive than they might be otherwise; as we have seen in 1982 when they went from a nominal 9-percent to a nominal 13-percent market share after the credit card reduction and their changed policy on how they were marketing.

Mr. BRITT. And you feel that is directly attributable to the different method they are using in the diminution of their windfall profits tax?

Mr. LANGDON. I say it is easy to be because they have that advantage in their raw material transfer price to their refineries.

Mr. BRITT. Thank you, Mr. Chairman.

Mr. BEDELL. Mr. Boehlert.

Mr. BOEHLERT. No questions.

Mr. BEDELL. Mr. Schaefer.

Mr. SCHAEFER. No questions.

Mr. BEDELL. We thank you very much for your testimony and appreciate you being here.

Our next panel consists of the representatives of the three major oil companies about which we have been talking.

I should tell you that they were very reluctant to come and sit at the same table, because of the concerns that they might have over antitrust to do. We are going to have before us James Kowal, manager, commercial and distributor sales, Atlantic Richfield Co.; Ronald A. McGimpsey, senior vice president of Sohio Oil Co., and Robert Doyle, vice president of supply, Exxon Co.

Would you come forward, please.

I think they want to have it made clear that they are not appearing here as a panel. But in order to save time, we have asked them to appear at the same time.

PANEL CONSISTING OF JAMES D. KOWAL; RONALD A. McGIMPSEY; AND ROBERT J. DOYLE

TESTIMONY OF JAMES D. KOWAL, MANAGER, COMMERCIAL AND DISTRIBUTOR SALES, ARCO PETROLEUM PRODUCTS CO., ATLANTIC RICHFIELD CO.; ACCOMPANIED BY RICHARD C. MORSE, GENERAL COUNSEL

Mr. KOWAL. Mr. Chairman, James Kowal, from Atlantic Richfield Co.

With your permission, I have with me Richard C. Morse, the general counsel for Arco Petroleum Products Co.

Mr. BEDELL. Thank you. That is fine.

We will start with you, Mr. Kowal.

Mr. KOWAL. Mr. Chairman, I do respect your request of a 10-minute time limit. We have ranged across a wide number of topics this morning. I will do my best to accommodate that.

With your permission, first, I will waive reading my statement entirely.

Mr. BEDELL. You have my permission.

Mr. KOWAL. I would like to summarize two or three key points, and try to comment on some of the conversations that preceded our appearance.

The principal purpose of this hearing, as we understood it, was to answer the question: What effect will IRS ruling 83-124 have, if any, on gasoline retail marketing? And my answer is simple: None.

My interpretation of the ruling is that it does substantiate depletion accounting concepts, and the concept of a single price in the field, both of which are consistent with Arco's methodology.

It leaves a lot of questions still to be resolved, not, I think, in a regulatory forum, but rather in the process that deals with resolving conflicts in facts. The application, if you will, of tax principles and tax concepts to extremely complex, factual questions, that vary enormously between taxpayers.

Someone suggested to me, and I had some reservations about using, but they said if we were talking about the rule in tax to set the basis for the sale of your home, or to compute a taxable income on your home, can you imagine a tax law that says that a home has a value of x.

Tax just doesn't work that way. Tax law lays down very clearly the principles by which a value will be determined of a particular house, and that is the fact question to which the principles are applied.

We think the principles that we have been using have been, to some extent affirmed by the IRS ruling in question, and there are still many, many questions to be resolved.

But far more importantly to this committee, I think, is the fact that we believe, and contend, and assert, and are prepared to defend the concept that what is going on in the street with retail gasoline marketing is a function of the street and of the myriad of factors that are affecting the gasoline business in 1983.

We have seen conservation, fuel substitution, and a weak economy, which in the aggregate have brought down the demand for the product by 15 percent, ending a 40-year continuous increase in demand.

You take a 14-percent decrease in demand for the commodity that you are talking about, and then exacerbate it further by diminishing the demand for the services that are often sold with the product and you have a double whammy.

And we have seen the demand for service typically associated with the product dramatically change. We have seen self-serve go from less than 30 percent to over 70 percent, since 1973. Seventy per cent of the American consumers say, "I don't want to pay for the service. The gasoline price is bad enough. I'll pump it myself and save 10, 15, 20, 30, 35, 40 cents a gallon charge for that service."

A lot of the other services that relate to gasoline marketing in the traditional sense have also gone away. You know your car doesn't get lubricated in 1,000-mile cycles any more. It is 5,000, 7,000 miles. That means the man's lubrication business has been diminished by 80 percent.

You know your tires don't wear out in 12,000 to 15,000 miles any more; they go 50,000, 30,000 miles.

All across the board there have been revolutions in this business, largely masked by 8 years of controls, unleashed in 1981; and that is the turmoil in the marketplace in 1983.

Competition is inevitably enhanced when you have a reduction in demand, and there are going to be losers, and there will be survivors. That shake-out process is proper, we believe, and we have tried to position ourselves and our customers for the best chance of survivorship in that environment.

Our basic key, and I apologize to those of you who were here before, but we keep coming back to it; we spent 8 years getting ready for this.

You heard somebody say today, for example, that among his entire constituency, 1 penny could cost 10 percent share of market. Just think of one thing we did when we dropped the credit card and cut our price 3 cents.

If his constituency suffers a 10-percent market swing for a penny, just imagine what 3 cents did. Just one decision.

And we have done something in the neighborhood of a dozen major things that we are able to identify since 1970.

Our investments in refining versus the industry are all going down while theirs are going up because ours are behind us.

We spent $600 to $700 million, but it would be $2 billion if we tried to do it today. Those bucks are paid. They have been amortized. We are positioned. We are looking at a daily refinery average of 172,000 barrels. The industry is something in the seventies.

There are economies of scale in getting yourself positioned that way. We were the last company, excuse me, the first company to sell a major refinery in the United States. We sold it in 1975. Bit the bullet and got out in the middle of the United States, in east Chicago. We also built one of the last grassroots modern refineries in the State of Washington. Our capacity then is 2.5 times the average. Our capacity is 2.5 times the average and our runs are hitting 100 percent, while the industry today is running at 70 percent.

Again, maximum economies of scale from the plant. Our sour crude capability, the cruddy stuff that is also the cheap stuff. We are able to run 91 percent sour crude. The industry average is

somewhere in the midfifties. Those economies all begin to pile up, when you pick up a quarter of a cent here and you pick up another *couple of cents, and you just keep building.*

We took 55 sales organizations and eliminated 50 of them, in retail gasoline marketing alone. Now, that is not our only game. The same thing has gone on in wholesale, and asphalt and coke and airlines, and all the other things we do. But in gasoline marketing, can you imagine having 55 sales organizations and deciding you are going to do it with 5?

We took 7,500 gas stations and decided that 5,000 of them were unnecessary; and consolidated down to 2,500.

We have advocated self-serve, to respond to the consumer's drive. The No. 1 factor in survey after survey with the consumer's price. Self-serve was the one way to respond to that, and we did it. We developed franchises to increase the financial flexibility of our dealers. Our LD throughputs today, gentlemen, are 2.5 times the industry average. And one of the problems I beg you to think about for a minute.

All the testimony you have heard today has something to do with crude off in Alaska and a street price, and they attribute everything to Arco.

But, gentlemen, think about it: We have 2,500 service stations doing over 150,000 gallons a month, and the dealer is making money like crazy, on a 3- and 4-cent margin, when the competitors are still trying to get the Lundberg average 9 and 10 cents. Of what you ultimately see on the street 5 or 6 cents isn't even ours. It is not even attributable to Arco. It is an Arco dealer saying, "I was making a dime at 50,000; I think I will go for a nickel on 150,000, and increase my income by 50 percent." They are doing it. Landslide across the country.

I'm sorry; do you have a question? That is dealer economics.

Mr. BEDELL. I think the feeling sir, is that we are short on time, and we want you to be heard, but our issue has to do with whether or Arco is getting a cost advantage because of the way our tax laws are being implemented——

Mr. KOWAL. Let me go right to that subject.

Mr. BEDELL. The committee's main concern is whether or not the Government is acting in such a manner to cause unfairness in the competitive marketplace.

Mr. KOWAL. Mr. Bedell, I am going to very, very, very respectfully disagree if I may, just this far.

The reason I am running you through this, I am going to suggest that all of this other stuff is a constructed argument to mask the fact that we are for real. They are going to keep coming at us, and we are going to keep coming back, and we are going to keep telling you how we are doing it. Now, the next thing that I want to do is to tell you how we are not doing it.

Mr. BEDELL. OK, but we are short on time.

Mr. KOWAL. May I comment on just some of the things that have been said in the previous 2 hours.

Mr. BEDELL. We have been hearing about what a great company Arco is, and your 10 minutes has expired. However, you may proceed.

Mr. KOWAL. I am biased. I have to admit that. In a Salomon Bros. research report published August 24, 1983, they indicated that they had talked to one of the GAO officers who had met with Congressman Nelson. They described the $500 to $800 million tax underpayment as "extremely soft." That is currently unsubstantiated. It is just another piece. It is not intended to set that whole conversation or that testimony aside, but we have got some very major unresolved problems, and we are getting different versions on it.

I cannot comment on a report that will be published next December. I don't have any idea where they are coming from, or what their points are. I think it would be a waste of your time. I do want to contend with one item, and it was not Congressman Nelson, but during his testimony, somebody said, "Arco filed a waiver yesterday."

I want to set that straight, because it sounds like we are getting our show in line for today. We filed a waiver last spring, like we always do. It is perfectly routine. IRS comes to you and says, "Look, we are still looking at 1980. The 3 years are coming up. You know how this works. You have got to waive all your rights, or we are going to hit you with a jeopardy assessment."

We do it every year. We filed a waiver last spring for the year 1980 that runs through next March, and if they don't have it done by then, or we have made some progress, we will have to work out a new waiver, but I did want to dispel a concept that we have done something on the eve of this hearing, Mr. Chairman.

The fact that our price zones are not published remains true, Congressman, for the same reason that we indicated last time. We are not a regulated industry. Our competition is free to move around any way they want to; we don't want to draw targets on ourselves, which is what a price zone would give a fellow, because then he knows where to target you and where not to lower prices if he is going to challenge it.

We won't publish them. They have been reviewed, and they are subject to being reviewed by proper authority. Mr. Chisholm did indicate that our market share was up substantially, in California, that is 2 percent. It has gone from something in the 10-plus range to something in the 13 range, and in Pennsylvania, was his other example. I don't believe it has gone up at all. If anything, it is going down, but he indicated he filed that data with the committee, and we will do our research, too, and if I am wrong, we will address that in a supplementary filing. He indicated in the course of his testimony the possibility of a 4-year payout on the TAPS tariff. Gentlemen, that comes close to being disingenuous when you realize that we are talking about; if you took the TAPS tariff, collected by all the owner companies, and applied it to the cost of building the pipeline, the cash payout would be 4 years.

What it ignores are little things like interest, taxes, and operating expenses. Would you have anybody evaluate your business and say your front-end cash register would pay out your total investment in the business in 4 years, and accuse you of somehow pricing too high, if in fact they didn't deduct the cost of the rent and the employees and the goods and all the other things that have to come

out of the tariff. I just don't think that the 4-year payouts in the area ought to continue to be repeated.

Now, with respect to Mr. Langdon, and with respect——

Mr. BEDELL. Excuse me—what he said was that the cost was $9.4 billion and the annual revenue was $3.5 billion.

Mr. KOWAL. That is gross revenue. That is what is in the cash register.

Mr. BEDELL. Yes. But that is not a 4-year payout, sir. That is less than a 3-year payout, if you are going to take 3.5 by 3, you get 10.50, which is significantly more——

Mr. KOWAL. If you don't have to pay any interest, and if you don't have to pay any taxes, and it doesn't cost you to run the pipeline; it is a 3-year payout; that makes it an even more disingenuous characterization of the transaction.

Mr. BEDELL. No, sir. What I am saying is that he did not indicate that he had not considered those other costs. If you take $3.5 billion times 4 years, you have $14 billion against a cost of $9.4 billion. So, he allowed $4 billion for something, whether that was for interest or what, I do not know, sir.

Mr. KOWAL. I don't know what he meant, but I know that pipeline can't be paid for, Mr. Bedell, and we will submit the economics.

[See app. D for additional information.]

Mr. BEDELL. That is all we want.

Mr. KOWAL. Now, I agree that at the rates charged, which are somewhere around $6, there is a lot of arguing going on about whether there ought to be 5, 10, or 20 cents one way or another; maybe a quarter. That is the magnitude of this whole dispute, a quarter. Now, if there is something wrong with that $6 rate, because it is going to pay this thing off in 3.5 years, we should be talking about a $1 tariff.

Mr. BEDELL. I think we are probably wasting our time on that. We need to get to get FERC before us, and meet with them.

Mr. KOWAL. With respect to the Tosco testimony, I am at a disadvantage in the sense that, while he was kind enough to compliment us for the data we have revealed, we are at somewhat of a disadvantage respecting Tosco's situation. I did hear him say that they are not a crude producer, and they don't have stations, so I think we are talking about a merchant refiner.

What I do not know, and therefore, can't comment on, is the price that he paid for his ANS crude that he buys through Philipps; nor do I know why he isn't paying the same price everybody else in California pays for California crude that he acquired through Getty and Philipps. It seems to me that he has put up to the committee an alternative price, if he tried to buy some other crude; but I don't know that he is, so I didn't follow that.

I have trouble.

Mr. BEDELL. Are you just about through, Mr. Kowal? Because it is a quarter of 12. What more do you have to say?

Mr. KOWAL. Well, market share representations were misstated.

Mr. BEDELL. OK.

Mr. KOWAL. Also, it seemed to me it would be interesting to realize that Tosco has the lowest gasoline price in San Francisco, and dropped it 2.5 cents yesterday. Of 10 people selling gasoline in Los

Angeles, only 2 are lower than Tosco, and in both markets Tosco is lower than I am.

I don't know how all that fits in. It is not intended to do anything except try to put some perspective around this. If he is at that kind of disadvantage, I don't know why he is selling cheaper than Arco is. The finished product, when he is only a merchant refiner, and that is his total market. There may be other factors.

I have trouble with Mr. Columbus' testimony. We have heard most of it before, but the concept that somehow California crude oil is only $1 less than the gulf is belied by a wealth of statistics that we have made available to many of you individually, and which if anybody has any interest in going into it today, I will be glad to do that.

I have to remind you that the independent gasoline marketers—Sigma—is a three times bigger marketer than Atlantic Richfield. Their average member is sitting on a $60 million a year business, and by their own handbook they are an association dedicated to politically shielding their members to assure survival and prosperity.

I welcome a fair fight. I don't mind being here, and I will be glad to try to handle your questions.

Mr. BEDELL. Thank you very much.

[Mr. Kowal's prepared statement follows:]

PREPARED STATEMENT OF JAMES D. KOWAL, MANAGER, COMMERCIAL AND DISTRIBUTOR SALES, ARCO PETROLEUM PRODUCTS CO., ATLANTIC RICHFIELD CO.

Atlantic Richfield Company is pleased to state our views to this Subcommittee about the effect, if any, on competition in the retail gasoline marketplace of the recently issued Internal Revenue Service (IRS) Ruling 83-124, concerning calculation of windfall profit tax (WPT) on Alaska North Slope (ANS) crude oil. We have stated our views as to how the WPT liability for ANS crude is to be determined under the particular circumstances of ANS crude production on a number of occasions. It is our opinion that we have been and continue to be in compliance with the WPT.

We believe two questions are at the heart of today's hearing: (1) the effect, if any, of the WPT in general and of Revenue Ruling 83-124 in particular on retail gasoline marketing and (2) other factors that actually may determine the highly competitive character of retail gasoline marketing today.

Atlantic Richfield does not believe that the Revenue Ruling will have any effect on gasoline marketing. Our retail price of gasoline is determined by competitive market forces unrelated to WPT considerations. Moreover, the Revenue Ruling, in our view, is consistent with, and supportive of, the methodology we believe should be used in calculating the WPT on ANS crude oil.

As we have said before, this methodology results in a taxable "removal price" at the North Slope which in turn yields a delivered cost to our refineries, both on the West Coast and in the Gulf, which is substantially the same, after grade and quality adjustments, as the delivered cost of most indigenous crude in those two areas.

The IRS is currently conducting a routine but thorough audit of all major ANS producers, including Atlantic Richfield Company. Given the fact that the proper determination of WPT liability for ANS crude involves a number of complex legal and factual issues, we continue to believe the IRS audit process is the best and proper forum for resolving those issues.

Furthermore, it appears to us that the entire issue of supposed WPT tax avoidance is raised by certain business concerns unprepared for the factors that actually do determine today's highly competitive gasoline market.

In fact, there is simply no connection between the process by which WPT liability on ANS crude oil is calculated and the substantial transformation that characterizes retail gasoline marketing. We should like to give our view of the key factors in today's gasoline marketplace and describe the marketing strategy we have developed to anticipate and capitalize on those factors.

The present U.S. gasoline market results from a number of trends which began in the 1970s. Contributing factors have been conservation efforts, substitution of other forms of energy and a generally weak economy. Those are the reasons for lower

demand and thus greater competition in the marketplace for gasoline, rather than the actions of any single oil company. This trend has resulted in a number of refinery shutdowns by both major and independent refiners and has reduced U.S. petroleum imports.

In 1978 gasoline demand in the United States peaked at 7.6 million barrels per day according to American Petroleum Institute statistics; since then, it has declined each year to an average of 6.5 million barrels per day in 1982, a cumulative decrease of over 14 percent.

This reduction is due to the greater fuel efficiency of the U.S. automotive fleet resulting from the Corporate Average Fuel Economy Standards (CAFE) set by the Energy Policy and Conservation Act of 1975 and the higher price of gasoline.

Another major impact on gasoline markets has been the change in customer preferences, especially the popularity of self-serve facilities. Rising petroleum costs in the 1970s, combined with increasing taxes on motor fuel, have heightened consumer sensitivity to price. Today, price is the single most important factor in the marketing of gasoline. Over 70 percent of all gasoline currently sold in the U.S. is purchased through lower priced selfserve facilities.

Finally, the removal of price and allocation controls in January 1981, has occasioned further adjustments in gasoline markets. Ten years of regulatory distortion of markets had generally discouraged innovation, contributed to inefficiency and fostered a system that sutained obsolete operations and in some instances actually rewarded nonproductive business behavior.

The combined effects of reduced demand, changing consumer preferences, regulatory distortions and a weak economy have resulted in a substantial shakeout in the number of participants and assets deployed in gasoline markets, including sales of non-productive assets and closing of facilities.

Some participants in the market took the difficult steps necessary to face this turbulent market even while controls and shortages made it unnecessary to take such efficiency measures. Consequently, the portfolio of market participants today have a wide diversity in terms of efficiencies. This has resulted in a plethora of allegations and demands for legislative remedies by those less prepared to compete in this changed environment. But, while all types of marketers have a place in the industry, only the most innovative and efficient will be successful.

Atlantic Richfield Company's marketing strategy is designed to respond to the changing marketplace. We have effectively planned for today's market and are well positioned to serve consumers who desire a quality product dispensed at a lower price.

Atlantic Richfield, early on, made major capital investments to upgrade refineries, while others still face them. We recognized that refinery output mix would have to shift to higher yields of gasoline and distillates. We also realized that world crude supplies would gradually decline in quality, making extensive refinery modifications necessary. In response, during the 1970s, at a total cost of $860 million, we modernized our refinery network into one of the industry's most efficient systems.

Were we to undertake these projects now, inflation and other factors would increase the cost to approximately $1.8 billion. Others in the industry, including both major and smaller companies, are now engaged in improvements in refining capabilities that represent investments of over $5.5 billion.

These investments and improvements in our refining system place us in a strong competitive position for the 1980s. This can be demonstrated by a few comparative operations statistics:

The average capacity of our refineries is 172,000 barrels per day versus an industry average of 72,000 barrels per day. Moreover, we realize economies of scale by operating at full capacity while the industry's average utilization rate is at the lower end of the 70 percent range.

Our sour crude processing capacity is 91 percent compared to approximately 55 percent for the industry. Sour crudes are more abundant and less costly than sweet crudes; thus we benefit from lower raw material costs.

Each of our refineries is strategically located on a deep-water port.

We have also taken major steps to improve our marketing operations. Where our low sales volume and high distribution costs did not justify our continued presence in the market, we withdrew from the area and sold our assets. In 1971, we marketed gasoline in 42 states; today we market in just 17 states—on the West Coast, in the Northeast, and in Metropolitan Chicago.

During this period we reduced the number of service stations and commensurately reduced personnel, both in refining and marketing.

However, the success of Atlantic Richfield Company's marketing program has not resulted solely from the streamlining of our operations. We have been at the fore-

front in introducing successful innovative practices to the marketplace. We were the first major oil company to launch self-serve on a national basis; we pioneered the mini-market concept that led to the implementation of our am/pm franchise program, and we introduced our MP&G (Mileage, Performance and Guarantee) franchise that successfully combines gasoline sales with a specialized automotive tune-up center facility.

To further bolster our moves to become an efficient, low-cost marketer, we eliminated the ARCO credit card effective April 15, 1982, passing the cost savings to our customers by cutting the price of gasoline.

We do employ a program for pricing to our dealers designed to help them stay competitive in small geographic areas in response to market pump price activity within those same areas. The price to our dealers in any given geographic area reflects a competitive price in that area. We can do no less for our dealer than to give then a competitive price, but obviously some competitors would like to have it otherwise. Where that competitive price includes credit, the price to our dealers reflect our savings.

We intend to remain competitively successful as a no-frills marketer of quality products, based on our long-term commitment to refining and marketing efficiency and innovation. The gains made by our marketing effort reflect our effective anticipation of, and response to, a highly competitive and shrinking overall gasoline market. One measure of our dramatically improved performance is the average gallonage throughout at our lessee dealer operated service stations. Our lessee dealer average throughout is now nearly two and one half times the industry average. It is clear the consumer has responsed favorably to our actions because the consumer has benefitted.

In conclusion, we believe the recent IRS Revenue Ruling is consistent with our view of proper compliance with the WPT. Moreover, our commitment to operational efficiency and innovation began long before the WPT was instituted.

Finally, Atlantic Richfield's marketing strategies will continue to respond to signals from individual retail markets. To the extent our market strategy changes, it will respond to competition in terms of overall innovation, the efficiency of our refining and distribution system and the good business practices of our dealers.

Mr. BEDELL. Mr. McGimpsey, we will hear from you next.

TESTIMONY OF RONALD A. McGIMPSEY, SENIOR VICE PRESIDENT, SOHIO OIL CO., STANDARD OIL CO. OF OHIO

Mr. MCGIMPSEY. My name is Ronald A. McGimpsey. I am a senior vice president of Sohio Oil Co., one of the business groups of the Standard Oil Co. of Ohio.

I am responsible for the crude oil trading and transportation activities of our downstream petroleum operations.

On February 23, 1983, before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, I testified in detail on Sohio's methodology of determining the wellhead netback value of Sadlerochit crude oil. In order to save time today, I will not discuss that methodology in detail but will answer any questions you may have at the end of this testimony.

For reference purposes, I have included a copy of my February testimony with my written remarks for today's hearing.

Sohio markets its Alaskan North Slope [ANS] crude oil on the west coast, gulf coast, and Caribbean areas in competition with other waterborne crude oil and negotiates the price of its ANS crude oil on the basis of the prices our customers would pay to acquire competing crudes on a quality-adjusted basis.

The windfall profits tax removal price for Sadlerochit crude oil from the Alaskan North Slope is calculated by subtracting from the respective market prices the marine transportation costs for shipment to that market and the tariffs paid for shipments

through the trans-Alaska pipeline, and where applicable, the trans-Panama pipeline.

Sohio does not run significant quantities of ANS crude oil through its own refineries. Also, Sohio has no refining or retail marketing facilities on the west coast.

Since Sohio is the largest producer and marketer of ANS crude oil subject to the windfall profit tax, Revenue ruling 83-124 is of significant interest to us. A thorough review of that ruling by our tax and legal experts leads us to the conclusion that Sohio's methodology for determining the removal price of a barrel of Sadlerochit crude oil for windfall profit tax purposes is consistent with IRS interpretation of the law as expressed in Revenue ruling 83-124.

When crude oil is not sold at the wellhead such as is the case with ANS, the windfall profit tax statute requires that the constructive sales price for determining gross income from the property under Internal Revenue Code section 613—the percentage depletion rules—be used to determine the windfall profit tax removal price. The percentage depletion rules require use of a representative market or field price for purposes of determining gross income from the property if such a price exists. If not, the cases have used a price which is the third party sales price less nonproduction charges such as transportation: a netback price.

Revenue ruling 83-124 specifically rejects a netback determination of removal price based on Department of Energy regulations and any other netback methodology inconsistent with the percentage depletion rules. Neither the law nor the ruling, however, precludes the use of a netback methodology in determining removal price so long as the approach is consistent with the percentage depletion rules.

Because there is no representative market or field price for Sadlerochit crude oil, Sohio has applied a netback methodology under the percentage depletion rules in determining the windfall profit tax removal price. Sohio has abided by the law as interpreted by the Revenue ruling in the determination of its windfall profit tax liability. This ruling is consistent with what we understand the law to be, and what our practices have been.

In the absence of a representative field or market price for ANS crude oil, the only reasonable methodology for determining the removal price is on the basis of a netback determined in accordance with section 613.

Since the interpretation of the law by the IRS is consistent with Sohio's interpretation, this ruling will not result in any change in our windfall profit tax liability or reporting procedures. In addition, there will be no effect on our downstream marketing operations.

We will continue to sell and exchange ANS crude oil as we have in the past and utilize the results of those third party transactions to determine the wellhead netback. We will continue to market our gasoline and other refined products the same as we have in the past, responding to the changing needs and desires of our customers in the most competitive manner possible.

The Internal Revenue Service has had the windfall profit tax compliance of the major Sadlerochit producers under audit for some time. It is in possession of a vast array of facts which bear on

this complex issue, and, as Revenue ruling 83-124 indicates, it is moving actively toward a resolution of the removal price issue. Because the removal price of Sadlerochit crude is a question of fact, the Internal Revenue Service is uniquely qualified to reach a determination on the issue.

Sohio believes that it has determined its windfall profit tax liability correctly under the law as interpreted by Revenue ruling 83-124 and expects to resolve any outstanding issues in the normal course of the windfall profit tax audit.

I thank you for the opportunity to present Sohio's view on IRS ruling 83-124, and will be pleased to respond to your questions.

Mr. BEDELL. Thank you, Mr. McGimpsey.

[Mr. McGimpsey's prepared statement and attachment follow:]

PREPARED STATEMENT OF RONALD A. MCGIMPSEY, SENIOR VICE PRESIDENT, SOHIO OIL CO., STANDARD OIL CO. OF OHIO

My name is Ronald A. McGimpsey. I am a Senior Vice President of Sohio Oil Company, one of the business groups of the Standard Oil Company (Ohio). I am responsible for the crude oil trading and transportation activities of our downstream petroleum operations.

On February 23, 1983, before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, I testified in detail on Sohio's methodology of determining the wellhead netback value of Sadlerochit crude oil. In order to save time today, I will not discuss that methodology in detail but will answer any questions you may have at the end of this testimony. For reference purposes, I have included a copy of my February testimony with my written remarks for today's hearing.

Sohio markets its Alaskan North Slope ("ANS") crude oil in the West Coast, Gulf Coast and Caribbean areas in competition with other waterborne crude oil and negotiates the price of its ANS crude oil on the basis of the prices our customers would pay to acquire competing crudes on a quality-adjusted basis. The Windfall Profit Tax removal price of Sadlerochit crude oil from the Alaska North Slope is calculated by subtracting from the respective market prices the marine transportation costs for shipment to that market and the tariffs paid for shipments through the trans-Alaska pipeline and, where applicable, the trans-Panama pipeline. Sohio does not run significant quantities of ANS crude oil through its own refineries. Also, Sohio has no refining or retail marketing facilities on the West Coast.

Since Sohio is the largest producer and marketer of ANS crude oil subject to the Windfall Profits Tax, Revenue Ruling 83-124 is of significant interest to us. A thorough review of that ruling by our tax and legal experts leads us to the conclusion that Sohio's methodology for determining the removal price of a barrel of Sadlerochit crude oil for Windfall Profit Tax purposes is consistent with IRS interpretation of the law as expressed in Revenue Ruling 83-124.

When crude oil is not sold at the wellhead such as is the case with ANS, the Windfall Profit Tax statute requires that the constructive sales price for determining gross income from the property under Internal Revenue Code Section 613 (the percentage depletion rules) be used to determine the Windfall Profit Tax removal price. The percentage depletion rules require use of a representative market or field price for purposes of determining gross income from the property if such a price exists. If not, the cases have used a price which is the third party sales price less non-production charges such as transportation: a netback price.

Revenue Ruling 83-124 specifically rejects a netback determination of removal price based on Department of Energy regulations and any other netback methodology inconsistent with the percentage depletion rules. Neither the law nor the ruling, however, precludes the use of a netback methodology in determining removal price so long as the approach is consistent with the percentage depletion rules. Because there is no representative market or filed price for Sadlerochit crude oil, Sohio has applied a netback methodology under the percentage depletion rules in determining the Windfall Profit Tax removal price.

Sohio has abided by the law as interpreted by the revenue ruling in the determination of its Windfall Profit Tax liability. This ruling is consistent with what we understand the law to be and what our practices have been. In the absence of a representative field or market price for ANS crude oil, the only reasonable method-

ology for determining the removal price is on the basis of a netback determined in accordance with Section 613. Since the interpretation of the law by the IRS is consistent with Sohio's interpretation, this ruling will not result in any change in our Windfall Profit Tax liability or reporting procedures. In addition, there will be no effect on our downstream marketing operations. We will continue to sell and exchange ANS crude oil as we have in the past and utilize the results of those third party transactions to determine the wellhead netback. We will continue to market our gasoline and other refined products the same as we have in the past, responding to the changing needs and desires of our customers in the most competitive manner possible.

The Internal Revenue Service has had the Windfall Profit Tax compliance of the major Sadlerochit producers under audit for some time. It is the possession of a vast array of facts which bear on this complex issue and, as Revenue Ruling 83-124 indicates, it is moving actively toward a resolution of the removal price issue. Because the removal price of Sadlerochit crude is a question of fact, the Internal Revenue Service is uniquely qualified to reach a determination on the issue. Sohio believes that it has determined its Windfall Profit Tax liability correctly under the law as interpreted by Revenue Ruling 83-124 and expects to resolve any outstanding issues in the normal course of the Windfall Profit Tax audit.

I thank you for the opportunity to present Sohio's views on IRS Ruling 83-124 and will be pleased to respond to your questions.

ATTACHMENT TO PREPARED STATEMENT OF RONALD A. MCGIMPSEY, SENIOR VICE PRESIDENT, SOHIO OIL CO., STANDARD OIL CO. OF OHIO

My name is Ronald A. McGimpsey and I am a Senior Vice President of Sohio Oil Company, one of the business groups of The Standard Oil Company of Ohio. I am responsible for the crude trading and transportation activities of our downstream petroleum operations.

Sohio is the largest producer of Alaskan North Slope ("ANS") crude oil, having approximate interests of 50 percent in the Prudhoe Bay field and 9 percent in the Kuparuk field. Our current shares of net production from these fields are approximately 593,000 barrels per day and 4,000 barrels per day, respectively. In addition, we are responsible for marketing a portion of the State of Alaska's royalty oil, currently some 55,000 barrels per day. During 1982, approximately 40 percent of our ANS oil was placed on the West Coast, with the balance going to the Gulf Coast and Caribbean areas.

Sohio markets its ANS crude oil through sale and exchange arrangements on the West Coast, on the Gulf Coast and in the Caribbean area. We market the oil to our customers on a delivered basis, utilizing shipping contracts and a fleet of chartered U.S. flag tankers. We have secured our tanker requirements by both long and short term charters and we contract with outside parties to operate our long term chartered ships.

Sohio markets its oil in the several geographical areas mentioned in competition with offshore crude oils. We prefer to place our ANS on the West Coast because the lower transportation costs provide us with a higher netback value. However, Sohio does not have any West Coast downstream operations, and therefore must compete for placements to West Coast refiners with waterborne crude oils from the Middle East, Far East and Latin America. Indeed, when ANS production commenced in 1977, crudes from these sources were displaced by our ANS oil. We have always negotiated our prices on the basis of the prices our customers would pay to acquire competing crudes on a quality-adjusted basis. This also applies to the Gulf Coast and Caribbean where we are in competition with the same or comparable offshore crudes. Given the fact that competing offshore crude oils can be landed in either the West or Gulf Coast for about the same delivered price, Sohio's term ANS sales price has tended to be the same on both coasts.

Our refining facilities consist of two refineries located in Ohio and a third on the East Coast at Marcus Hook, Pennsylvania. These refineries have an aggregate throughput capacity of 456,000 barrels per calendar day. During 1982, our aggregate refinery runs averaged 361,000 barrels per day. In the 5½ years since ANS production commenced, Sohio has not shipped significant quantities of ANS crude into its own refining system.

Due to the characteristics of their physical plants, ANS crude is not a suitable supply for either of Sohio's two Ohio refineries. At times, some ANS crude has been shipped to the East Coast and refined at our Marcus Hook facility. The fact that Sohio does not refine significant quantities of ANS crude oil does not mean, howev-

er, that our ANS production has not provided us with a secure source for our refinery supply. Rather than transport ANS production east, Sohio has delivered ANS crude to West Coast customers in exchange for other domestic or offshore crudes to be run in our refining system. In order to provide sufficient crude of appropriate quality for our refining system, we have also sought exchanges in areas other than the West Coast. The medium of crude oil exchanges thus preserves Sohio's secure supply for our own system. The ANS source barrels for Sohio's downstream business are transferred into our refining system at the price received by Sohio from arm's length, third party sales in the same delivery area.

We determine our windfall profit tax obligation by starting with the actual value received from our arm's length, third party transactions. From this value, the marine transportation costs incurred for the applicable geographic destination are subtracted, together with the tariffs paid for shipments through the trans-Alaska pipeline and, where applicable, the trans-Panama pipeline. These calculations determine the removal price, upon which the windfall profit tax is applied.

Sohio has paid windfall profit taxes of $352.4 million, $1,366.1 million, and $515.4 million for the years 1980, 1981, and 1982, respectively.

My testimony has described the basic operations of Sohio's ANS crude oil activities.

Mr. BEDELL. Mr. Doyle.

Mr. DOYLE. Thank you, Mr. Chairman.

My statement is brief, and I do plan to read it this morning.

TESTIMONY OF ROBERT J. DOYLE, VICE PRESIDENT OF SUPPLY, EXXON CO., U.S.A.

Mr. DOYLE. My name is Robert J. Doyle, vice president of supply, Exxon Co., U.S.A. I am here in response to the subcommittee's inquiry regarding the possible effects of the Internal Revenue Service's Revenue ruling 83-124 on downstream gasoline marketing activities. Although I recognize the subcommittee's desire for a panel arrangement, I would like to make it clear for the record that my testimony and comments reflect only Exxon's position, and should not be viewed in any way as reflecting the opinions or positions of the other panel members.

Since Revenue ruling 83-124 deals with the method for calculating windfall profit tax for Alaskan North Slope Crude, I would first like to discuss the disposition of North Slope crude from an overall standpoint. A key consideration is that there is no significant outlet for North Slope crude at its point of production. In fact, over 95 percent of the crude must move out of Alaska. The closest tributary refining area for this crude is the U.S. west coast. Currently, the total availability of Alaskan, and indigenous west coast crude exceeds the requirements of west coast refineries by about 800,000 barrels a day. This volume, which represents about half of the North Slope production, must move to other areas. Since our country still must import about a third of its crude, it is logical and economical that this crude in excess of West Coast requirements, move to refineries east of the Rockies; mainly along the U.S. gulf, and east coast. Unlike other domestic crude, North Slope crude moves to a number of refining areas having a range of market prices, and requiring a range of transportation modes and costs.

With this background I will now discuss the recently issued Revenue ruling 83-124. Although the ruling is not clear in our view, it appears to require the use of a single removal price by all North Slope producers in determining windfall profit tax liability. Such an approach is clearly inconsistent with the disposition of North Slope crude that I just described. Clearly, there is no basis to estab-

lish a single representative removal price for all producers consistent with the fact situation. Individual producers each dispose of varying amounts of their oil in the various geographical areas noted depending on their individual refinery needs, and market outlets.

In the case of Exxon, we move about two-thirds of our ANS crude to our refineries and markets on the gulf east coast.

In addition to being inconsistent with the flow of North Slope crude, the ruling is also unworkable. For example, in order for Exxon to pay its windfall profit taxes, based on a single representative field price for all producers, it would require knowledge of the other producers' prices, and transportation costs. Such information is understandably not available to us or any other producers.

Finally, Exxon maintains that the IRS ruling is inconsistent with the law. The Crude Oil Windfall Profit Tax Act of 1980 specifically requires each North Slope producer to separately average his own removal prices each month. Clearly, Congress was well aware of the need for North Slope oil to go to multiple refinery locations. The congressional committee reports document that the statute provides a means for each producer to determine removal prices based on the destination of the oil, and the cost to transport the oil to that destination. The IRS ruling disregards these facts. An Exxon memorandum discussing the legal aspects of North Slope removal price determination has been filed with the IRS, and is submitted with this testimony to the subcommittee.

In view of the deficiencies of the Revenue ruling 83-124, Exxon believes that it should be withdrawn promptly. A new ruling should be issued that will require each producer to determine the competitive term commercial market price or value of North Slope crude in each area to which the oil is delivered. Each producer's transportation costs from the North Slope to this area should then be deducted to arrive at a wellhead value for the oil delivered to that area. The resulting individual producers wellhead values from each area in any calendar month should be weight-averaged by volume to determine an average value per barrel for use by that producer as the removal price in determining his windfall profit tax liability for a given month. Obviously, each individual producer's determination of market value and transportation cost is subject to audit by the Internal Revenue Service. This method, in our view, provides the only representative, and equitable basis, for determining windfall profit tax liability for North Slope crude.

In view of the difficulties noted with Revenue ruling 83-124, it is not possible to make any meaningful judgments on its impact on the gasoline marketplace. The connection apparently referred to in the subcommittee's inquiry is the relationship between the price used to determine a producers windfall profit tax liability, and that producer's refinery cost for in North Slope crude. While a general relationship does exist, refinery crude cost is only one of many factors that influence the price a consumer pays for gasoline at a service station. In our own case there is no direct identifiable relationship between the cost of our North Slope crude, and our dealer tank truck prices for gasoline.

Exxon's marketing vice president, R. C. Kiddoo, presented extensive testimony on marketing practices to the Energy Environment

and Safety Subcommittee in December 1982. A copy of that statement is also attached, and is submitted with this testimony.

To insure that there is no inequity among producers in the determination of windfall profit tax liability for North Slope crude, it is important that a new Revenue ruling along the lines I've discussed be issued promptly. It is also most important that the IRS conduct prompt audits to insure that all producers have, and are continuing to use prices and costs in their individual determinations that realistically represent the outlets served and the transportation modes used.

Mr. Chairman, I hope these comments are responsive to your inquiry. The statement, along with supporting data, has been submitted for the record. I request that we be able to submit additional information for the record should it be judged desirable as a result of this hearing. Thank you very much.

[Mr. Doyle's prepared statement follows:]

[See appendix E for additional material.]

Prepared Statement of Robert J. Doyle,
Vice President of Supply,
Exxon Co., U.S.A.

Good morning. My name is Robert J. Doyle, Vice President of Supply, Exxon Company, U.S.A. I am here in response to the Subcommittee's inquiry regarding the possible effects of the Internal Revenue Service's Revenue Ruling 83-124 on downstream gasoline marketing activities. Although I recognize the Subcommittee's desire for a panel arrangement, I would like to make it clear for the record that my testimony and comments reflect only Exxon's position and should not be viewed in any way as reflecting the opinions or positions of the other panel members.

Since Revenue Ruling 83-124 deals with the method for calculating windfall profit tax for Alaskan North Slope crude, I would first like to discuss the disposition of North Slope crude from an overall standpoint. A key consideration is that there is no significant outlet for North Slope crude at its point of production. In fact, over 95% of the crude must move out of Alaska. The closest tributary refining area for this crude is the West Coast. Currently the total availability of Alaskan and indigenous West Coast crude exceeds the requirements of West Coast refiners by over 800 kB/D. This volume, which represents about half of the North Slope production, must move to other areas. Since our country still must import about one-third of its crude, it is logical and economical that the crude in excess of West Coast requirements move to refineries east of the Rockies, mainly along the U.S. Gulf and East Coasts. Unlike other domestic crude, North Slope crude moves to a number of refinery areas having a range of market prices and requiring a range of transportation modes and costs.

With this background, I will now discuss the recently issued Revenue Ruling 83-124. Although the Ruling is not clear, it appears to require the use of a single removal price by all North Slope producers in determining windfall profit tax liability. Such an approach is clearly inconsistent with the disposition of North Slope crude I just described. Clearly there is no basis to establish a single representative removal price for all producers consistent with the fact situation. Individual producers each dispose of varying amounts of their oil in the various geographical areas noted depending on their individual refinery needs and market outlets.

In addition to being inconsistent with the flow of North Slope crude, the Ruling is also unworkable. For example, in order for Exxon to pay its windfall profit taxes based on a single representative field price for all producers, it would require knowledge of the other producers' prices and transportation costs. Such information is understandably not available to us or any other producer.

Finally, Exxon maintains that the IRS ruling is inconsistent with the law. The Crude Oil Windfall Profit Tax Act of 1980 specifically requires each North Slope producer to separately average his own removal prices each month. Clearly, Congress was well aware of the need for North Slope oil to go to multiple refinery locations. The Congressional Committee reports document that the statute provides a means for each producer to determine removal prices based on the destination of the oil and the cost to transport the oil to that destination. The IRS ruling disregards these facts. An Exxon memorandum discussing the legal aspects of North Slope removal price determination has been filed with the IRS and is submitted with this testimony to the Subcommittee.

In view of the deficiencies in Revenue Ruling 83-.24, Exxon believes that it should be withdrawn promptly. A new Ruling should be issued that will require each producer to determine the competitive term commercial market price or value of North Slope oil in each area to which the oil is delivered. Each producer's transportation cost from the North Slope to this area should be deducted to arrive at a wellhead value for oil delivered to that area. The resulting individual producer's wellhead values from each area in any calendar month should be weight averaged by volume to determine an average value per barrel for use by that producer as the removal price in determining his windfall profit tax liability for a given month. Obviously, each individual producer's determination of market value and transportation cost is subject to audit by the Internal Revenue Service. This method in our view provides the only representative and equitable basis for determining windfall profit tax liability for North Slope crude.

In view of the difficulties noted with Revenue Ruling 83-124, it is not possible to make any meaningful judgment on its impact on the gasoline marketplace. The connection apparently referred to in the Subcommittee's inquiry is the relationship between the price used to determine a producer's windfall profit tax liability and that

producer's refinery cost for North Slope crude. While a general relationship does exist, refinery crude cost is only one of many factors that influence the price a consumer pays for gasoline at a service station. In our own case, there is no direct identifiable relationship between the cost of our North Slope crude and our dealer tank truck prices for gasoline.

Exxon's Marketing Vice President, R. C. Kiddoo, presented extensive testimony on marketing practices to the Energy Environment and Safety Subcommittee in December 1982. A copy of his statement is submitted with this testimony.

To ensure that there is no inequity among producers in the determination of windfall profit tax liability for North Slope crude, it is important that a new Revenue Ruling along the lines I discussed be issued promptly. It is also most important that the IRS conduct prompt audits to ensure that all producers have and are continuing to use prices and costs in their individual determinations that realistically represent the outlets served and transportation modes used.

Mr. Chairman, I hope these comments are responsive to your inquiry. This statement, along with supporting data, has been submitted for the record. I request that we be able to submit additional information for the record should it be judged desirable as a result of this hearing. Thank you.

Mr. BEDELL. We thank you very much, Mr. Doyle, for your testimony. I think your testimony clearly indicates that the three of you are not in collusion, in view of the content of your testimony. I would advise the members of the subcommittee, particularly those who are attorneys, of the information that you have attached to your testimony from Exxon.

[See Exxon testimony.]

Mr. BEDELL. I think it documents clearly why the congressional intent was not what has been provided by the recent ruling by the IRS. I encourage members to read this information if they have time.

Mr. Conte is with us now, the ranking minority member. I'll call on you first, Mr. Conte. Do you have any questions?

Mr. CONTE. Well, first of all, I want to take this opportunity to compliment my chairman, Mr. Bedell, for calling these hearings on this very vexing, and important issue. Now, Mr. Doyle, has your method of determining your windfall profit tax changed in any way since 1980?

Mr. DOYLE. No, sir.

Mr. CONTE. If you want to do away with this ruling 83-124, as withdrawn, as you recommended here, what would the impact be on the windfall profit tax?

Mr. DOYLE. Sir, our recommendation is that the new ruling be issued along the lines that we have been calculating our windfall profit tax since its inception. So it would have no impact.

Mr. CONTE. You don't think it will have any impact?

Mr. DOYLE. Not on the windfall profit tax we pay.

Now, I think I ought to make the point again that there may be an issue in terms of the data that is submitted by ourselves, and I'm sure the other companies, in determining the windfall profit tax, such as our estimate of the marketplace in the gulf coast, and on the west coast, and the transportation components that we use for transportation from the North Slope to those markets. They are certainly open to question by the Internal Revenue, and we'll be prepared to defend those, but at this point that's certainly an area for further discussion with the service.

Mr. CONTE. Have you changed your accounting procedures as a result of 83-124?

Mr. DOYLE. Well, as I mentioned in my testimony, we're having a real hard time understanding 83-124, and we really have not at this point been able to determine how we're going to handle it if that ruling stands.

Mr. BEDELL. Would the gentleman yield on that point?

We've handed the ruling around to the members of the subcommittee. I'm not a lawyer, but I sure as heck can't understand it. If some of the members can, it sure would be beneficial if at some time they would inform us as to exactly what that ruling says.

Mr. CONTE. But in answer to my question, you have not changed your accounting procedures?

Mr. DOYLE. No, sir. As I say, the ruling is unclear, and we do not file our next quarterly windfall profit tax return for another couple months.

Mr. CONTE. Mr. Kowal, the testimony you presented is rather puzzling in one major respect. You claim there's no connection between your method of calculation for the windfall profit tax, and the retail gas market.

Doesn't the windfall profit tax act as a cost of doing business to Arco? Do you figure that in?

Mr. KOWAL. It is not something you can ignore obviously, but it doesn't set our price on the street. Mr. Conte, it obviously would be a point if you try to keep up with competition, and all of your costs in the aggregate didn't give you a profit, and that's one of your costs, you're not going to survive.

Mr. BEDELL. Would the gentleman yield?

Mr. KOWAL. The windfall profit tax doesn't set the street price, is what I'm saying.

Mr. BEDELL. Will the gentleman yield?

Mr. KOWAL. Sure.

Mr. BEDELL. This is just absolutely ridiculous. If one company saves 5 cents a gallon on taxes, that company has a competitive edge in the marketplace, and for you to indicate that you don't think that's the case, Mr. Kowal, I think is just absolutely ridiculous.

Mr. KOWAL. Well, Mr. Bedell, one of the difficulties we have is we keep talking like Arco took Alaskan North Slope oil in a vacuum and put it in California.

Now, one of the difficulties, and we went into this at great length with the previous testimony, if you took the State of California as an example, California has 1.7 million barrels a day of refining ca-

pacity that's running. All the refiners there are—is 1.7 million a day runs—excuse me, actual runs, not capacity. And 1.1 million barrels of that is produced in California at the exact same price that all the Alaskan North Slope oil comes down, the other 500.

See, our 500 doesn't get to the California market where the price is different than the million one that's already there that's owned by all the other people. Let me clarify that: about 850,000 barrels of the total is refined by the fellow who bought it out of the ground on a long-term lease via posting. Every day 850,000 barrels are bought at the same price that my Alaska oil gets there for.

Now, there is another 120,000 barrels a day on top of that that Tosco gets but not in its own name. They buy it from Phillips out of the North Slope. I don't know what Phillips charges them. They buy it from Phillips and Getty as posters in the State of California paying the same prices as Mobil, Shell, Exxon, Union, and all the other people that post, which happens to be the same price I pay for the oil that I bring from Alaska. That only leave 140,000 barrels.

Mr. SISISKY. Excuse me. Will the gentleman yield for a moment.

Mr. KOWAL. Yes, sir.

Mr. SISISKY. They may pay the same price, but that doesn't exclude the taxes that you're not paying on it.

Mr. KOWAL. They don't pay any tax. They don't pay any tax. The producer pays the tax.

Mr. SISISKY. Yeah, exactly.

Mr. KOWAL. So Tosco is paying the price for the oil that the Atlantic Richfield Products Co. is paying for the oil. If you let these people tell you that my refining and marketing is very profitable. I'm not getting any money from the production company. I'm not getting any money from the transportation company. The Arco Petroleum Products Co. is doing extremely well, and we're paying the same price they are.

Mr. SISISKY. But you are not paying the same taxes is what the argument is, not over the profits.

Mr. KOWAL. I'm sorry, but Tosco doesn't pay any tax either. They're not a producer, neither am I.

Mr. BILIRAKIS. Will the gentleman yield?

You say there's no connection between the saving on the part of Arco and windfall profit tax, and the retail gas market?

Mr. KOWAL. That's right.

Mr. BILIRAKIS. Where does that savings then go? Is that added to your profit?

Mr. KOWAL. If there were a saving it would have to be over in our oil and gas company, if there were a savings.

Mr. BILIRAKIS. You don't acknowledge that by using your system, your methodology, that you are paying less windfall profits tax than you would if you used the methodology used by Sohio, and Exxon?

Mr. KOWAL. Oh, now, Mr. Bilirakis, let me be extremely careful with you.

Mr. BEDELL. And brief if you could.

Mr. KOWAL. I believe historically, 1980 until today, depending on a lot of unknown facts, I don't think there would be a significant difference. We've been above them, and below them over time. If

California were the market, and we don't happen to think it is, because it's a blatantly surplus market with a lot of problems, but if California's oil prices were the price that were used, at least historically, we think we'd come out about paying the same tax we have.

We have another way to get there.

Mr. BEDELL. I think we have to recess to go vote. We've got a little bit of a problem. Mr. Chapoton is waiting in the next room, and I'm sure we're very anxious to talk to him as well. But this is kind of a golden opportunity, I think, for us to try to straighten out some of the concerns that we have.

Mr. Sisisky has just mentioned to me that we have to vote on the conference report on the defense bill. Let's try to make it back in 10 minutes.

[A short recess was taken.]

Mr. BEDELL. Because of the shortage of time, we'll go ahead and start while the other members are returning.

Mr. Ray?

Mr. RAY. I don't have any questions of this gentleman.

Mr. BEDELL. Mr. Kowal, I've got a chart here that was given to us by Arco, which shows the shipping charges for ANS crude oil. And according to this chart it shows that the transportation charge from Valdez to Watson, Calif., is $1.31. The shipping charge from Valdez to Houston is $5.59. Are you acquainted with those figures, and are those the Arco figures?

Mr. KOWAL. Mr. Chairman, they sound about right at a point in time. I don't have that chart in front of me, but I think the order of magnitude is about right.

Mr. BEDELL. You testified that you thought the dollar difference in cost was incorrect in regard to the differential between California and Texas crude. What do you consider that difference to be?

Mr. KOWAL. Closer to $3.

Mr. BEDELL. We have a chart right here supplied by Platt's Industry Week. Is that a reputable organization?

Mr. KOWAL. I'm familiar with it.

Mr. BEDELL. If you take what they show as the average sales to the west coast, and the U.S. gulf coast differential from 1981 through 1983, the average differential is $1.40. Do you think that's pretty basic?

[See app. F.]

Mr. KOWAL. Mr. Bedell, I do not believe that that has been quality adjusted. I think those are raw prices for postings. They do not take into account sulfur differences, or gravity differences, which all go to the value of oil. Value of oil, which is a different one from the other. If you are going to compare them, you have to compare apples and apples.

That only tells us what the postings are for kinds of oil. If you're a refiner you have to then adjust that for its value.

Mr. BEDELL. So you think that $1.40 value is wrong?

Mr. KOWAL. No, I think it's misleading. It's not wrong. It's absolutely accurate. That's the difference in posting. It is not the value. It doesn't purport to be, I don't think.

Mr. BEDELL. You apparently show a difference of $4 in the transportation costs between the oil in California and the oil in Texas.

Mr. Kowal, I think it's pretty understandable to this person why you price it at Texas price.

I hope you know; we're not being critical of you. I'm not very pleased with your testimony. I think you act like we may not have very good sense on our subcommittee. In terms of your company, I don't blame your company a bit. Any company would try not to pay any more taxes than they have to pay. If IRS is going to let you get away with that sort of thing, then I don't blame you for trying to do it. But I think for you to indicate to this subcommittee that taxes don't have anything to do with profits, or what you sell your product for in the marketplace, is sort of an insult to the intelligence of the subcommittee, if I might be so bold as to say so.

Mr. KOWAL. Mr. Bedell, I'm sorry, but I think I did say it would have a great deal to do with your profits. I said it didn't have anything to do with the price of gasoline on the street to the consumer.

Mr. BEDELL. Well, if you think we're stupid enough to believe that, then I think again it's kind of an insult to at least this member of the subcommittee, and I don't know how the other members of the subcommittee feel. I'll yield to Mr. Sisisky.

Mr. SISISKY. Thank you, Mr. Chairman.

Mr. Kowal, I came out of the marketing field of an industry that is highly marketed. Probably more than the oil company. I understand what the function of the street is. I was a street fighter, and understand very well that the market changed. No question about it; the market changed.

I am concerned, however, with your trade zone analysis. May I ask you, what is your major State in your marketing area? I'm sure that's no trade secret. California?

Mr. KOWAL. Major by share, major by volume, major by numbers?

Mr. SISISKY. By volume. Or is that a company——

Mr. KOWAL. It's not a secret, no. I suspect that Pennsylvania and California are pretty close in terms of volume. Market share would be higher in Philadelphia because it's a smaller population, and smaller in California, but those are two key States.

Mr. SISISKY. You made a big thrust of saying that you've been very efficient, particularly in your marketing. I made a statement before that I don't think it's the purpose of the U.S. Congress to interfere in the normal course of business in those who are efficient, and smart marketingwise, and should have the fruits of that kind of thing. I am a little concerned, and I wonder if you would explain, you talked about your 2,500 marketing outlets now. Do you control those outlets in the pricing of those outlets in many manner, shape, or form?

Mr. KOWAL. No, sir.

Mr. SISISKY. They're independent operators operating from a price that you set, and you do not set their retail price? It has no connection between your wholesale price and your retail price? Is that what you're saying, sir?

Mr. KOWAL. In concept, yes, but Mr. Sisisky, if you'll permit me, I have to clarify two things. The number 2,500 that you heard is the number of stations that we owned. In terms of reducing the cost of capital to run a marketing operation, I told you we went from 7,500 owned, to 2,500. That's an accurate number. However,

that's not all the Arco stations there are. There are another 1,000 to 1,500 stations that are owned by the fellow who's running it, and there's another 1,000——

Mr. SISISKY. Let's talk about the 2,500, which are your major outlets——

Mr. KOWAL. Out of that 2,500, there are approximately 400 which are run by one of our subsidiaries, and in that sense they pay the same price. They pay the same rent, but one of our subsidiaries does set the resale price at those outlets. The other 2,100.

Mr. SISISKY. How about the other 2,100. You do not have any control over the pricing? In other words, in your trade zone, and I know this is a touchy subject, in your trade zone you've got a market of $1 a gallon, your competitors $1 a gallon. You do not tell your dealer that we will cut the price to you, but all we want your markup to be is *x* number of cents per gallon?

Mr. KOWAL. Absolutely not.

Mr. SISISKY. I know that's illegal, but there are many controls over that, of course, too, in the controls. Isn't that 2,100. Do you own the property also, sir?

Mr. KOWAL. That's what I meant.

Mr. SISISKY. You own the property?

Mr. KOWAL. We own the property.

Mr. SISISKY. But you have individual operators?

Mr. KOWAL. Yes, sir.

Mr. SISISKY. OK; you get the thrust of what I'm talking about. The real problem, and again, if you're efficient, and other companies are not efficient, and by golly, you should have the fruits of your labor, but we come back to the reason this committee is meeting, and that's the windfall profit tax.

Now, you heard testimony from Mr. Doyle, I think, that said that they do not agree, their tax attorneys do not agree with the Internal Revenue regulation. You said you do agree with it, and you've been vindicated. Well, good lawyers can differ on that. But you still have an advantage over other companies, and I'm sure there are other companies doing it your way too, particularly these companies doing it their way. Now, let me ask you a question, do you own your transportation companies? I know about the pipeline, but tell me about your shipping companies.

Mr. KOWAL. Well, the pipeline is part of the transportation company. The transportation company is a separate company of Arco that has our pipelines and our ships.

Mr. SISISKY. So you own the shipping companies too?

Mr. KOWAL. We have some ships that that company owns, yes, sir, and we charter ships that other people——

Mr. SISISKY. You charter those ships from your own transportation company at the price that who sets? Is that FERC that sets that price, or you set the price on your ships?

Mr. KOWAL. There's an organization the acronym of which is USFRA, U.S. Freight something or other, whose job it is to determine the value of ships in Jones Act trade, because it's not world trade, it's an isolated market, there is an organization that determines weekly, or monthly, or daily the value of a ship in Jones Act trade.

Now, you may have one because of when you bought it, and what it cost you to operate, that rate's profitable to you, there are other people in Jones——

Mr. SISISKY. Well, you know what I'm getting at. Who's setting the rates that you're paying to take that oil theoretically around to the gulf coast, or Texas?

Mr. KOWAL. An outside organization.

Mr. SISISKY. An outside organization does set their rates.

Mr. KOWAL. Telling us what the industry is having to pay.

Mr. SISISKY. Is your company a foreign subsidiary by any chance? Do you go out of a 200-mile zone from a tax standpoint? There's a quirk in the tax laws somewhere about taking products 200 miles off the coast.

Is your company involved in that in any way? Is it a foreign subsidiary of foreign——

Mr. KOWAL. It's a U.S. company.

Mr. SISISKY. OK.

Mr. KOWAL. But I believe that the phenomenons you're describing applies even to U.S. companies whose activities are offshore.

Mr. SISISKY. Right.

Mr. KOWAL. My understanding that was part of the industry picture until 1980 or 1981, and that phased out.

Mr. SISISKY. So it's not——

Mr. KOWAL. It's not a factor today.

Mr. SISISKY. It's not a factor.

Mr. BEDELL. Would the gentleman yield now?

Mr. SISISKY. Yes, sir.

Mr. BEDELL. Are you saying that today you have to pay income taxes on your shipping regardless of whether it goes outside the 200-mile limit or not?

Mr. KOWAL. Mr. Bedell, we also have ships that go to Indonesia, and other places.

Mr. BEDELL. No, no, from Valdez to California.

Mr. KOWAL. I am still outside my area of expertise, and I'd like to submit an answer to that question.

Mr. BEDELL. Well, does the gentleman with you know?

Mr. KOWAL. I just turned to him.

Mr. BEDELL. All right. I can read you the IRS ruling, and that may have been changed, but the IRS ruling says that "that tax will be applicable only if and is traveling in U.S. territorial waters." It would appear to me there's some IRS ruling that exempts you from having to pay income taxes on those charters if you go outside U.S. waters.

Can you answer that? Do you operate your own ships?

Mr. MCGIMPSEY. We do not operate our own.

Mr. BEDELL. Does Exxon?

Mr. DOYLE. Of our ANS, about 70 percent is moved in outside charters, which are third party, arms-length negotiations, and about 30 percent on our own vessels. Those vessels are owned by a U.S. company.

My understanding is that the revenue earned when they are traveling outside the national waters is looked at as foreign source income. The foreign source income is subject to U.S. income taxes, and only to the extent that there are foreign tax credits that offset

it does one have an offset on the income that is earned in the international waters, if you will.

Mr. BEDELL. So you expect an airline flying from Valdez to California, if it went outside the 200-mile limit, to get similar preferential treatment, would you not?

Mr. DOYLE. Mr. Bedell, this is not something to my knowledge that's just for the movements of ANS crude. I don't know how the airlines calculate——

Mr. BEDELL. Thank you.

Mr. SISISKY. Mr. Chairman, I just brought up the point, in order to say that it's not all efficiency in marketing that makes up a pricing structure. It has to do with taxes, both windfall profits, and even ordinary income taxes. Because of the time, Mr. Chairman, I do have some more, but I'll defer to someone else.

Mr. BEDELL. Mr. Conte, were you through?

Mr. CONTE. Just one series of last questions to any of the members witnesses.

Do you all agree that the Alaskan North Slope oil is a fungible product?

Mr. KOWAL. Arco does. That is from field to field. You do get some differences you move around, but within a field, yes, sir.

Mr. CONTE. Well, there's no difference in any of the oil coming from the Sadlerochit, is there?

Mr. KOWAL. I think within a miniscule variation in degrees from day to day that the Sadlerochit is essentially fungible; yes.

Mr. CONTE. Do you all agree on that?

Mr. MCGIMPSEY. I agree to that.

Mr. CONTE. Do you all calculate your removal price from pump station 1, or in close proximity to that?

Mr. KOWAL. Arco is based on pump station 1.

Mr. CONTE. Right. Well, if the oil is all fungible, and a removal price is theoretically determined at the same spot, or close proximity to that one spot, why shouldn't the Internal Revenue Service just establish a removal price, and let the transportation costs be determined by standard rate to the various refineries?

Mr. DOYLE. If I might answer that, sir, at least from an Exxon point of view.

I pointed out in my testimony that the ANS crude is moving to a number of different areas in the United States. It moves to the west coast, and it moves to the gulf, east coast. We don't believe there is a single removal price that is going to be representative from all the areas that the oil goes to, because the market prices on the west coast, and the gulf coast at times, are out of transportation parity. I think that's really what the guts of this whole discussion is about today. So if you set a single price up on a slope, it would not reflect the differences among the areas to which this crude moves.

Mr. CONTE. You just set a standard rate for the removal though from a slope to the gulf coast?

Mr. DOYLE. Well, the issue is if you set a single price on the North Slope, and then add transportation, you would effectively have the delivered price, or cost, for everyone in transportation parity, to the west coast, or the gulf coast.

What we have seen in the market information we have is that the markets have not been in transportation parody. In other words, for the gulf and west coast to be in transportation parity using the number the chairman indicated earlier—let's say it's $4 difference—you would expect the price difference between the gulf coast and the west coast to be $4. In other words, the gulf coast to be $4 higher than the west coast.

Mr. CONTE. Right.

Mr. DOYLE. In fact, what you've seen in the marketplace as we view it, is a difference anywhere from $1 to $2 higher on the gulf coast, and not the $4 higher.

That's why we feel you really have to start from the destination that the oil goes to, and work backwards rather than start from the North Slope and go forward. Because we're going into the markets, or areas where the price is not always in transportation parity. Market forces dictate what those prices are.

Mr. CONTE. Thank you, Mr. Doyle.

Mr. BEDELL. Mr. Bilirakis.

Mr. KOWAL. Mr. Conte, Arco's answer to the question would obviously be quite different. We believe that it would be appropriate to have a removal price, a single price for the field.

Now, at the moment, applying what I understand to be, and I'm not a tax lawyer, traditional concepts of percentage depletion which seems to be where we would have thought the IRS would go, and where it seems that they're going, is a way to do that. I would shudder at the thought of just setting a number. If you haven't looked at the facts of where the stuff is going to get back to that price, and I gather that that's the process, the technical fact finding process that's going on now, how do you set that single number?

We have no objection to setting a number, but it does not seem to us that we just come out of a vacuum. It would depend on the facts of where that oil is going. Those are the traditional tax approach methodologies in which such a price as the one you've asked about would normally be established. That's the process I understand is underway.

Mr. CONTE. The reason that Arco would agree with that concept, is Arco is the producer, Arco owns the transportation, and Arco owns the refinery.

Mr. KOWAL. I don't think that the answer would be any different, Mr. Conte. If it didn't have any one of those three. That's the way the tax law normally works.

Mr. BEDELL. Mr. Bilirakis?

Mr. BILIRAKIS. Thank you, Mr. Chairman.

Mr. McGimpsey, according to the second page of your testimony, since the interpretation of the law by the IRS is consistent with Sohio's interpretation, this ruling will not result in any change in our windfall profit tax liability, or reporting procedures, and you go on, there will be no effect on our downstream marketing operations. We will continue to sell and exchange ANS crude oil as we have in the past, et cetera. We will continue to market our gasoline, other refined products the same as we have in the past.

Would your answer be different if the ultimate decision were made that the Arco interpretation is the correct interpretation of what was intended by the writers of that legislation?

Mr. McGIMPSEY. I think our answer would be different, because what was suggested by the previous line of questioning, if you had one removal price for all Alaskan oil, it would be to the benefit of those who take their oil to the west coast, as opposed to companies such as ourselves, who market the majority of our oil on the gulf coast.

In effect, you'd end up paying a tax on expenses we were incurring to move that oil the additional distance, which would be totally inappropriate. I think the windfall profits tax was established as a tax on so-called windfall profits. We start with the market price, in our determination, that we actually receive from a third party. Subtract the expenses from that to get back to something to base a tax upon on a profit margin.

Certainly, if we went to a totally different methodology, it would effect our whole strategy on the crude oil side, not on the retail marketing side.

Mr. BILIRAKIS. What would be the end result of that? Would that amount to more profit to the company, lower tank truck prices, or a little bit of both?

Mr. McGIMPSEY. I would suspect that it would probably end up with less profit to the company, depending on how the interpretation were made. It would not effect our——

Mr. BILIRAKIS. You'd be paying less windfall profits tax, would you not?

Mr. McGIMPSEY. Depending on how that price was derived. If it were related to exactly how Arco is doing it, we'd probably be paying less. I could also foresee where it could work the other way. As far as downstream operations, our downstream operations are located in the Midwest and the East. As I mentioned in our testimony, we do not refine significant quantities of ANS crude oil, so I don't believe it would have any effect on those operations.

Mr. BILIRAKIS. Thank you, sir.

Mr. Doyle, you say that in your case there's no direct identifiable relationship between the cost of your North Slope crude, and your dealer tank truck prices for gasoline.

Does that mean in determining your costs for your north oil crude, you take into consideration the windfall profit tax that you pay?

Mr. DOYLE. Yes.

Mr. BILIRAKIS. That's part of your cost, is it not?

Mr. DOYLE. But I think the point that I wanted to make was that certainly over time the cost of crude oil is a factor since if you take your retail service station price, and let's just for the sake of argument say it's $1.30, probably 70 to 75 cents is made up of crude oil. So obviously over some period of time, if the crude oil price goes up, or the crude oil price goes down, it is going to have some impact on the overall market.

The point I was trying to make is there are so many other factors affecting the price of gasoline in a particular service station, and I can use refining costs. I can use distribution, tank truck costs——

Mr. BILIRAKIS. There are many points.

Mr. DOYLE [continuing]. Margins that the dealers have, and so on. But you can't say over a short period of time that, if your ANS price is up, or your ANS price goes down, that at a particular service station you ought to see the price go up an equivalent amount, or down an equivalent amount.

Mr. BILIRAKIS. Well, that's a commonsense thought, I would say, sir, but over the long haul——

Mr. DOYLE. Certainly crude oil costs will influence cost, and you would expect over time if everybody stays in business, that you have to, make some money versus your cost.

Mr. BILIRAKIS. Well, the point that we were making, Mr. Chairman, of Mr. Kowal, was that point continued during my absence? We talked about the windfall profit tax that ordinarily the company would have paid if they had interpreted it similarly, the act similar to the way Sohio and Exxon had it.

Mr. BEDELL. I think the answer is it was continued. I think Mr. Kowal's opinion is that taxes have nothing to do with price in the marketplace. I think there are members on the committee that do not agree with that belief, and I have the impression that the committee is not going to convince Mr. Kowal. At least Mr. Kowal is not going to convince this member of the committee, that taxes have nothing to do with it.

Mr. BILIRAKIS. Mr. Kowal, all of the points that you've set out I think are valid points. Efficiency is certainly very significant; good refining; good production, all of these things. I don't think there's anybody on this committee who that would deny Arco making a better profit because they're a better company, if you will. They function in a better manner.

Of course, if they make that profit as a result of not putting proper taxes into the taxpayers coffers, wrongfully, that's a different situation. I'm not for one moment saying that your interpretation is incorrect. I don't know whether it is or whether it isn't, and that's a point that concerns me.

Thank you, Mr. Chairman.

Mr. BEDELL. Before we adjourn there are two things I'd like to do. I would like to introduce into the record the issue paper by the American Law Division of the Congressional Research Service on this particular issue.

[See app. G.]

Mr. BEDELL. We should get a copy to each of the members of the committee as well.

This issue paper states that the ruling does not provide an adequate guidance on determination of transportation costs, which has been a major focus of concern. The ruling does not specifically approve or disapprove the methodology of any of the three majors. I think that's one of our concerns. I should also point out, since you mentioned, Mr. Kowal, a Solomon Bros. quotation from their reports, which reads as follows:

> From figure 3 we calculate our current west coast transfer price for crude or bay oil to be about $25 per barrel. This represents a $2 per barrel, 5 cents per gallon, cost advantage over Sohio's current west coast price of $27 per barrel.

Mr. Schaefer, did you have any questions?

Mr. SCHAEFER. One quick question. Sorry.

About this 83-124 not being clear and precise, what major points——

It seems to be a jumbled mess for you.

Mr. DOYLE. There can be many interpretations and that's my problem about it being unclear. That that ruling did call for a single representative price on the North Slope. As I've tried to point out in my testimony, and in answer to your questions, we don't believe there is a single representative price on the North Slope; so that's the first problem with it.

The second problem is we do not really believe that it is consistent with the congressional background for the windfall profit tax law. Following the questioning of Mr. Conte, in the congressional papers, I know you'll find a section where it states, unlike other domestic oils, Sadlerochit is a crude that's delivered to different refining areas and as such must be treated differently. That is in the memorandum that we have included behind my testimony, and submitted to the subcommittee.

The third area is if it is a single representative price, we don't know how to calculate that single representative price, because the only data that we're privy to are our own data in time, and in fact, ever, to process the windfall profit tax return.

So we have those three problem areas with the regulation of the rulings.

Mr. BEDELL. Thank you.

We appreciate your testimony very much, Mr. Doyle. I'm sorry we didn't have more time.

As I indicated at the beginning of the subcommittee session, Mr. Chapoton wanted to meet with us in private. We will meet with him in order to discuss our concerns, and afterward to discuss with the press any questions that they might have.

Thank you very much for your testimony.

[Whereupon, at 12:46 p.m. the subcommittee adjourned to reconvene subject to call of the Chair.]

APPENDIXES

APPENDIX A.—REVENUE RULING 83-124

DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, PUBLIC AFFAIRS DIVISION—NEWS RELEASE, AUGUST 8, 1983

WASHINGTON.—The Internal Revenue Service today issued a revenue ruling that explains how to figure the removal price of a barrel of Alaska North Slope crude oil for the windfall profit tax.

The revenue ruling states that the method used for determining gross income from the property for purposes of the depletion allowance should also be used to figure the windfall profit tax removal price. Rev. Rul. 83-124 is attached and will appear in Internal Revenue Bulletin No. 1983-34, dated Aug. 22, 1983.

* * * * * * *

REVENUE RULING 83-124

ISSUE

Whether the first sales price determination under Department of Energy (DOE) pricing regulations should be followed in determining the "removal price" for Alaska North Slope crude oil removed from the premises before sale for purposes of the Crude Oil Windfall Profit Tax under section 4988 of the Internal Revenue Code.

LAW AND ANALYSIS

Section 4988(c) of the Code provides the general rule that the term "removal price" means the amount for which a barrel of crude oil is sold. The section further provides that, when crude oil is removed from the premises before sale or if crude oil is sold to a related person, the constructive sales price for determining gross income from the property under section 613 of the Code is used to determine the removal price. In addition, section 51.4988-1(b)(1) of the Excise Tax Regulations provides, in part, that if crude oil is removed (or deemed removed) from the premises before it is sold, the removal price shall be equal to the amount that results (or would result) from application of the constructive sales price principles under section 613 for purposes of determining gross income from the property (regardless of whether gross income from the property is actually increased by reason of that oil.)

Section 1.613-3(a) of the Income Tax Regulations provides that "gross income from the property" means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

In describing the need for the constructive sales price rules for depletion and windfall profit tax purposes, the Finance Committee Report ("Senate report") accompanying the Crude Oil Windfall Profit Tax Act of 1980, S. Rep. 96-394, 96th Cong., 1st Sess., states at page 54, 1980-3 C.B. 172, "In the past, taxpayers may have sought to increase the size of their depletion deduction by means of artificial transactions. In such an instance, the determination of a constructive sale price has reduced the amount of gross income from the property for depletion purposes. If oil is sold for an artificially low price, the windfall profit tax would be imposed on the higher constructive sale price." In addition to making the constructive sales price rules applicable to the windfall profit tax, Congress provided in section 4996(f) of the

28-101 O - 84 - 6

Code that in determining the removal price of oil from a property in any transaction, the Secretary may adjust the removal price to reflect the fair market value of the oil removed. The Senate report states that the purpose of this rule is to ensure that transactions are not arranged primarily to avoid the windfall profit tax. The Senate report also makes clear that this rule applies to transactions between unrelated, as well as those between related, parties. (See Senate report at page 65, 1980–3 C.B. 183.)

Section 4996(d)(1) of the Code provides that the removal price of Sadlerochit oil removed during any calendar month shall be the average of the producer's removal prices for such month.

In describing the need for the monthly averaging of removal prices for Sadlerochit oil, the Senate report states parenthetically at page 37, 1980–3 C.B. 155, "Unlike other oil, North Slope oil will have a range of wellhead prices in a particular month depending on the final destination of the oil because each integrated producer determines the wellhead price for each barrel by subtracting transportation costs from the price of the oil at the refinery gate." This statement was not intended to override the specific provisions in section 4988(c) that require the removal price to be determined under the principles contained in section 613 in the case of crude oil removed from the premises before sale or crude oil sold to a related party. Rather, in the case of Sadlerochit oil that is removed from the premises before sale or sold to a related party, section 4996(d)(1) was intended to apply to removal prices as determined under the principles contained in section 613. This Senate report language is not, for example, authority to disregard the section 4988(c) definition and use a computation provided for in DOE pricing regulations (such as a "net-back" computation) in determining the removal price of oil from the Alaska North Slope where use of the "net-back" computation is inconsistent with section 613 principles.

The language contained in section 4988(c) is clear and unambiguous. This language is not inconsistent with the language in section 4996(d)(1), which is also clear and unambiguous. The Senate report language explaining section 4996(d)(1) does not state that section 4988(c) is inapplicable to Sadlerochit oil. However, even if it could be so interpreted, it would not be authority to override clear and unambiguous statutory provisions. Where language used in a statute is clear and unambiguous, the legislative intent must be derived therefrom, notwithstanding that the intent expressed therein may conflict with the Committee reports of Congress. (*Helvering* v. *City Bank Farmers Trust Co.*, 296 U.S. 85 (1935).) In the instant case, where there can be no doubt of the meaning of the words in the statute, there is no need to look behind its plain meaning.

HOLDING

The appropriate method, as provided by statute, for determining the "removal price" for Alaska North Slope crude oil removed from the premises before sale for purposes of the Crude Oil Windfall Profit Tax is the method based on the principles for determining gross income from the property under section 613 of the Code without regard to DOE pricing regulations for determining first sales price.

APPENDIX B.—LETTER FROM REPRESENTATIVE BILL NELSON TO CHAIRMAN BEDELL

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
August 3, 1983.

Hon. BERKLEY BEDELL,
Chairman, Subcommittee on General Oversight and the Economy, Committee on Small Business, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Last December, as Chairman of the Budget Committee's Task Force on Tax Policy, I requested that the General Accounting Office (GAO) study the computation of the Windfall Profit Tax on oil taken from the Alaskan North Slope.

I want to share this information with you as the Chairman of the Subcommittee on General Oversight and the Economy and personally to offer to assist you as this problem is brought to light.

Based on an oral briefing of the pending report, due to come out in December 1983, GAO estimates that the Federal Government is losing approximately $500–$800 million annually in revenues because the oil companies have various methods of computation that result in a considerable underestimate of the well-head price. The Administration has been lax in issuing the appropriate regulations for a correct interpretation of the Windfall Profit Tax law which was passed in March 1980. As a result, the statute of limitations may have already run out on some of the earlier losses of revenue to the Federal Government.

Because of your obvious interest in this issue, I am enclosing several documents that the GAO has furnished to me in their oral briefing. While they do not spell out the conclusions of the GAO, they may help to highlight the scope of the problem.

I have requested that the Chairman of the House Ways and Means Committee include a provision in the mark-up of upcoming legislation that would facilitate the exchange of taxpayer information between the IRS and the State of Alaska. This would be invaluable information to the IRS as they promulgate the long-overdue regulations to determine a consistent well-head price on the Alaskan North Slope.

I look forward to assisting you in resolving this problem as further information becomes available. As soon as the GAO report is complete, I shall forward a copy of it to you for your perusal. I hope that this information is useful to you.

Thank you for your attention to this matter.

Sincerely,

BILL NELSON.

Enclosure.

APPENDIX C.—SUBCOMMITTEE CORRESPONDENCE WITH FERC, AND OTHERS, RE TRANS-ALASKA PIPELINE

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON GENERAL OVERSIGHT AND THE ECONOMY,
Washington, D.C., September 21, 1983.

Hon. CHARLES M. BUTLER III,
Chairman, Federal Energy Regulatory Commission,
Washington, D.C.

DEAR CHAIRMAN BUTLER: On September 15, the Small Business Committee's Oversight Subcommittee held a hearing to explore allegations by independent gasoline marketers that some major integrated producers of Alaska North Slope (ANS) crude oil were underestimating the well-head value of their ANS crude by artificially inflating the costs of transporting the oil to the market. These marketers claim that this allows major integrated ANS crude oil producers to underpay their windfall profits tax by an amount large enough to significantly lower their retail gasoline prices and gain a substantial competitive advantage over other refiners and marketers who do not have access to ANS crude oil.

During the question and answer sessions with our witnesses, members of the Subcommittee were informed that the major owners of the Trans-Alaska crude oil pipeline may be earning a rate of return far above the rate envisioned for conventional business investments on the oil that is transported through the pipeline. The suggestion was also made that improperly high per-barrel transportation rates on ANS crude oil shipped through the pipeline serve to reduce the appropriate windfall profits tax payments to the Federal Treasury. The independent marketers and refiners who testified before our panel were unanimous in their opinion that subsidies in the form or underpayments of windfall profits taxes stemming from the artificial inflation of transportation costs on ANS crude oil puts them at a competitive disadvantage in the gasoline marketplace.

Mr. Butler, a number of questions were raised during our September 15 hearing that we believe should be addressed by the Federal Energy Regulatory Commission. It would be helpful to our deliberations to have your office provide us with a history of the actions taken by FERC, its predecessor agencies, and the courts to regulate transportation rates on the trans-Alaska crude oil pipeline.

Included in that history it would be helpful to have a brief summary of the amounts invested in the pipeline by the individual owners as of January 1, 1980. We would also like a breakdown of the current operating expenses, including the costs of interest and debt service incurred by the owners of the pipeline in the past three years. We would further like the Commission to provide us with a history of the rates earned on the pipeline by the 5 largest owners in the individual years since decontrol.

The Subcommittee would also like to know if the rates currently being charged by the pipeline owners are FERC-approved, and if the Commission has future plans to review these rates. Finally, does FERC have jurisdiction to set and regulate the transportation rates on ANS crude oil that is shipped by tanker between U.S. ports? If not, who does?

Mr. Butler, after reviewing the requested information, the Oversight Subcommittee would like to schedule a meeting with your office to discuss this matter further. Accordingly, it would be appreciated if your office could supply us with the requested information in two weeks.

If you have any questions about this request, please contact Mark Levine of the Oversight Subcommittee staff, at 225–8944.

Sincerely,

BERKLEY BEDELL.
Chairman.

RICHARD RAY.
ROBIN BRITT.
NORMAN SISISKY.
SILVIO CONTE,
Ranking member.
MICHAEL BILIRAKIS.
SHERWOOD BOEHLERT.
DAN SCHAEFER.

FEDERAL ENERGY REGULATORY COMMISSION,
Washington, D.C., October 19, 1983.

Hon. BERKLEY BEDELL,
Chairman, Subcommittee on General Oversight and the Economy, Committee on Small Business, House of Representatives, Washington, D.C.

DEAR CHAIRMAN BEDELL: Thank you for your letter of September 21, 1983, requesting information relating to pipeline earnings and the history of the rates for the transportation of Alaska North Slope (ANS) crude oil through the Trans Alaska Pipeline System (TAPS). Enclosed for your information are the answers to your questions.

The rates currently being charged by the pipeline owners have not been approved by the Federal Energy Regulatory Commission (Commission). Those rates are currently under review and will be reduced if the evidence now being tried so warrants. Refunds together with appropriate interest may also be ordered.

Schedules attached hereto show the following:

(A) Investment as of January 1, 1980, three year history of (1) Operating expenses; (2) Interest cost; and (3) Debt service cost.

(B) Rates of return earned on the pipeline by the four largest owners each year since decontrol. These four companies own 91.7 percent of the TAPS system.

(C) Rate history.

To the best of our knowledge and understanding and to the extent the requested information is in our files, our response is accurate. For the most effective use of our limited financial resources, our staff completed audits of only two of the respondent companies—ARCO and Exxon Pipe Line Company and performed audits on portions of the other pipeline companies. This limited investigation was sufficient in the proceeding since the State of Alaska was conducting its own investigation of each pipeline. Also, staff's evidence concerning these two companies in most instances is applicable to the other six companies as well. Most of this information has been presented by the adversary parties in the rate proceeding. The conclusions reached by the FERC Staff are being contested by the owners.

Initial rates were filed by the owner companies with the Interstate Commerce Commission (ICC) early in 1977 (The "Filed Tariffs" in the appended Schedule C). These rates average about $6.20 per barrel transported from the ANS to Valdez, Alaska. The ICC suspended these rates for the statutory maximum of seven months and substituted "interim" rates averaging about $4.84 per barrel for use during the suspension period. Upon termination of the suspension period in January, 1978, the pipeline owners commenced charging the filed rates ($6.20). The filed rates, however, are subject to refund for amounts collected in excess of rates ultimately allowed by this Commission and the Courts. The ICC suspension order and the "interim" rates were ultimately sustained by the U.S. Supreme Court.

The ICC suspension order also required that an investigation be made to determine the lawful rates which could be charged by the pipeline. That process has continued, first under the ICC, and since October 1, 1977, here at the FERC. Hearings on rate methodology were held in 1978 and 1979, with additional hearings scheduled for January, 1984. The discovery process, which permits each party limited entry into the records of each of the other parties, was initiated in 1979 and concluded in 1981. Hearings on the evidence taken during the discovery period began in February, 1982, and have continued intermittently since that time. Additional evidence on tariff rates, costs of operation, dismantling, income taxes and certain other related cost of service items is scheduled to be filed in October, 1983. Hearings on those and related allocation and tariff issues should be completed by the end of 1983. Additional evidence on construction issues is due in January, 1984, and those hearings are expected to be completed in 1984. To date, 324 days have been devoted to the hearing process, during which close to 50,000 pages of testimony have been transcribed, and uncounted thousands of pages of additional testimony and exhibits have been admitted into the record.

The Commission has ruled on a number of issues related to the proceedings, including jurisdictional matters, interest on refunds, and depreciation rates. The great body of issues are not ripe for decision at this time. However, all issues are now scheduled for hearing. Barring unforeseen procedural delays, these hearings should conclude in approximately one year. Thereafter, the presiding Administrative Law Judge will write an initial decision which in a normal case would be published within three to nine months after the close of hearings. If the Judge's decision is appealed, the Commission will then issue its opinion. Further appeals may be directed to the Federal District and Supreme Courts. Neither the timing of this chain of legal decisions nor the extent of appeals to these orders are predictable. Pending final decision or settlement, the rates filed by the owners remain in effect, subject to refund.

This Commission does not have statutory authority to regulate transportation rates for tanker shipments between U.S. Ports. Common carrier tariffs for tanker shipments are filed with the ICC pursuant to the Intercoastal Shipping Act (46 CFR part 53), commonly known as the Jones Act. Where both the ship and the oil are owned by the same company, the shipping rate is not regulated. Our understanding is that crude oil shipped out of Valdez is transported in vessels owned or leased by the owners of the crude, and are not common carriers subject to the tariff requirements of the Intercoastal Shipping Act. This subject may be explored in greater depth by contacting Mr. Charles Thompson of the ICC at 275-7720.

I believe the foregoing discussion, together with the attachments, answers the questions contained in your letter. Please contact me if your Subcommittee feels it is necessary or desirable to discuss these matters further or if you need answers to additional questions.

Sincerely,

A. G. SOUSA,
Acting Chairman.

Enclosures.

SCHEDULE A

[In thousands of dollars]

	January 1980	1980	1981	1982
AMERADA HESS PIPELINE CORP.				
1. Investment:				
Depreciable property				
Land				
C.W.I.P.				
Total investment	144,630			
Accrued depreciation	13,861			
Net plant	130,769			
2. Operating expenses		13,971	14,429	12,264
3. Interest expenses [1]		6,079	4,568	3,068
4. Debt service cost [2]		11,306	9,820	8,348
ARCO PIPE LINE CO.				
1. Investment:				
Depreciable property				
Land				
C.W.I.P.				
Total investment	1,957,833			
Accrued depreciation	177,310			
Net plant	1,780,523			
2. Operating expenses		198,939	206,672	178,918
3. Interest expenses [1]		129,129	130,390	89,035
4. Debt service cost [2]		157,692	322,997	487,551
BP PIPELINES, INC.				
1. Investment:				
Depreciable property				

SCHEDULE A—Continued

[In thousands of dollars]

	January 1980	1980	1981	1982
Land				
C.W.I.P.				
Total investment	1,491,538			
Accrued depreciation	156,610			
Net plant	1,334,928			
2. Operating expenses		149,867	15,349	138,122
3. Interest expenses [1]		103,330	97,294	92,071
4. Debt service cost [2]		129,232	149,908	144,919
EXXON PIPELINE CO.				
1. Investment:				
Depreciable property				
Land				
C.W.I.P.				
Total investment	1,825,515			
Accrued depreciation	179,808			
Net plant	1,645,707			
2. Operating expenses		182,190	188,745	168,480
3. Interest expenses [1]		111,035	100,468	99,654
4. Debt service cost [2]		270,829	260,110	110,154
MOBIL ALASKA PIPELINE CO.				
1. Investment:				
Depreciable property				
Land				
C.W.I.P.				
Total investment	461,034			
Accrued depreciation	45,206			
Net plant	415,828			
2. Operating expenses		45,767	40,110	36,017
3. Interest expenses [1]		28,967	28,863	28,788
4. Debt service cost [2]		28,959	28,950	28,951
PHILLIPS ALASKA PIPELINE CORP.				
1. Investment:				
Depreciable property				
Land				
C.W.I.P.				
Total investment	147,663			
Accrued depreciation	14,811			
Net plant	132,852			
2. Operating expenses		13,353	11,555	9,958
3. Interest expenses [1]		10,066	10,027	9,997
4. Debt service cost [2]		10,364	10,275	10,080
SOHIO PIPELINE CO.				
1. Investment:				
Depreciable property				
Land				
C.W.I.P.				
Total investment	3,176,755			

SCHEDULE A—Continued

[In thousands of dollars]

	January 1980	1980	1981	1982
Accrued depreciation	305,996			
Net plant	2,870,759			
2. Operating expenses		299,052	285,032	269,707
3. Interest expenses [1]		239,655	227,137	215,508
4. Debt service cost [2]		294,545	338,140	327,189
UNION ALASKA PIPELINE CO.				
1. Investment:				
Depreciable property				
Land				
C.W.I.P.				
Total investment	145,925			
Accrued depreciation	14,010			
Net plant	131,915			
2. Operating expenses		13,704	12,388	10,198
3. Interest expenses [1]		8,364	8,053	7,561
4. Debt service cost [2]		8,331	13,689	13,260

[1] Per income statement.
[2] Includes interest costs.

SCHEDULE B—RATE OF RETURN

	Company position	State of Alaska position	FERC staff position
ARCO PIPE LINE			
1980:			
Revenues	$711,557	$711,557	$711,557
Operating expenses	$185,773	$171,265	$174,464
Income taxes claimed	$208,632	$15,314	$40,628
Carrier income	$317,152	$524,978	$496,465
Rate base claimed	$2,035,451	$1,202,941	$1,420,389
Rate of return (percent)	15.58	43.64	34.95
1981:			
Revenues	$717,505	$717,505	$717,505
Operating expenses	$203,554	$177,709	$182,914
Income taxes claimed	$245,953	$22,091	$38,086
Carrier income	$267,998	$517,705	$496,505
Rate base claimed	$1,960,038	$1,150,376	$154,193
Rate of return (percent)	16.67	45.00	36.66
1982:			
Revenues	(1)	$728,402	$728,402
Operating expenses	(1)	$158,433	$162,663
Income taxes claimed	(1)	($8,201)	$22,148
Carrier income	(1)	$578,170	$543,591
Rate base claimed	(1)	$1,071,298	$1,280,447
Rate of return (percent)	(1)	53.97	42.45
BP PIPELINES, INC.			
1980:			
Revenues	$556,820	$556,820	(1)
Operating expenses	$149,123	$125,621	(1)
Income taxes claimed	$167,690	$6,181	(1)
Carrier income	$240,007	$425,018	(1)
Rate base claimed	$607,086	$906,169	(1)
Rate of return (percent)	14.93	46.90	(1)
1981:			
Revenues	$583,842	$583,842	(1)
Operating expenses	$152,891	$131,395	(1)

SCHEDULE B—RATE OF RETURN—Continued

	Company position	State of Alaska position	FERC staff position
Income taxes claimed	$188,605	$14,702	(1)
Carrier income	$242,346	$437,745	(1)
Rate base claimed	$1,544,028	$897,478	(1)
Rate of return (percent)	15.70	48.78	(1)
1982:			
Revenues	(1)	$587,752	(1)
Operating expenses	(1)	$115,635	(1)
Income taxes claimed	(1)	($4,372)	(1)
Carrier income	(1)	$476,489	(1)
Rate base claimed	(1)	$838,220	(1)
Rate of return (percent)	(1)	56.85	(1)
EXXON PIPELINE CO.			
1980:			
Revenues	$696,124	$696,124	$696,124
Operating expenses	$170,098	$153,413	$157,186
Income taxes claimed	$217,946	$28,426	$51,262
Carrier income	$308,080	$514,285	$487,676
Rate base claimed	$1,879,600	$1,157,602	$1,360,043
Rate of return (percent)	16.39	44.43	35.86
1981:			
Revenues	$695,997	$695,997	$695,997
Operating expenses	$175,465	$157,051	$161,701
Income taxes claimed	$231,695	$50,442	$56,286
Carrier income	$288,846	$488,504	$478,010
Rate base claimed	$1,842,510	$1,115,888	$1,296,687
Rate of return (percent)	15.68	43.78	36.86
1982:			
Revenues	$633,512	$633,512	$633,512
Operating expenses	$170,069	$137,985	$142,492
Income taxes claimed	$215,950	$15,883	$36,711
Carrier income	$247,493	$479,644	$454,309
Rate base claimed	$2,081,591	$1,049,663	$1,225,627
Rate of return (percent)	11.89	45.70	37.07
SOHIO PIPE LINE CO.			
1980:			
Revenues	$1,130,970	$1,130,970	(1)
Operating expenses	$300,864	$257,664	(1)
Income taxes claimed	$311,146	($3,461)	(1)
Carrier income	$518,960	$876,767	(1)
Rate base claimed	$3,236,091	$1,882,005	(1)
Rate of return (percent)	16.04	46.59	(1)
1981:			
Revenues	$1,128,837	$1,128,837	(1)
Operating expenses	$307,820	$260,171	(1)
Income taxes claimed	$329,440	($1,998)	(1)
Carrier income	$491,577	$870,664	(1)
Rate base claimed	$3,107,892	$1,774,751	(1)
Rate of return (percent)	15.82	49.06	(1)
1982:			
Revenues	(1)	$1,240,846	(1)
Operating expenses	(1)	$227,218	(1)
Income taxes claimed	(1)	($23,810)	(1)
Carrier income	(1)	$1,037,438	(1)
Rate base claimed	(1)	$1,666,484	(1)
Rate of return (percent)	(1)	62.25	(1)

[1] Not available.

SCHEDULE C.—TRANS-ALASKA PIPELINE SYSTEM—INTERSTATE TARIFF RATES

[Per barrel]

Owner Company	ICC tariffs [1]	Filed tariffs [2]
Amerada Hess Pipeline Corp	$4.85	$6.44
ARCO Pipe Line Co. [5]	4.91	6.04
BP Pipelines, Inc. [5]	4.68	[3] 6.35/5.40
Exxon Pipeline Co	5.10	[4] 6.27/5.30
Mobil Alaska Pipeline Co	4.84	6.31
Phillips Alaska Pipeline Corp	4.83	6.22
Sohio Pipe Line Co	4.70	6.16
Union Alaska Pipeline Co	4.89	6.09
Weighted average rate	4.84	6.20

([1]) In effect from date of initial service to expiratioin of the ICC suspension period during January 1978.
([2]) In effect subsequent to the ICC suspension period.
([3]) BP reduced its rate to $5.40 per barrel from July 1, 1982 to Nov. 1, 1983.
([4]) Exxon reduced its rate to $5.30 per barrel from Jan. 1, 1982 to Oct. 19, 1983.
([5]) ARCO and BP levy a surcharge for oil originating in the Kuparuk reservoir.

FEDERAL ENERGY REGULATORY COMMISSION,
Washington, D.C., November 9, 1983.

Hon. BERKLEY BEDELL,
Chairman, Subcommittee on General Oversight and the Economy, Committee on Small Business, House of Representatives, Washington, D.C.

DEAR CHAIRMAN BEDELL: The Commission has recently received several inquiries expressing concern over the possible misinterpretation of the information contained in my letter to you dated October 19, 1983. The attachment marked Schedule B seems to be of particular concern.

In your letter to former Chairman Butler dated September 21, 1983, you requested that the F.E.R.C. furnish rate of return figures on the largest owners of the Trans Alaska Pipeline System (TAPS). Schedule B was intended as a response to that request. Unfortunately, Schedule B was mischaracterized on the first page of my letter. Schedule B does not contain the rates of return earned by the owners. Rather, Schedule B purports to contain figures which were represented to me by Commission staff as those presented by the various parties in the pending TAPS rate case.

Today, staff advised me that the rate of return figures attributed to the State of Alaska and the F.E.R.C. (trial) staff were not presented by those parties. In addition, staff has informed me that there may be a mismatch between the revenues and the income taxes claimed. There is also a question on the appropriate method for determining the tax figure itself. Therefore, I cannot assure you unequivocally that Schedule B contains accurate information, or reflects the positions of the parties. In any event, reliance on the figures in Schedule B as representative of the true return to the TAPS owners prior to a Commission decision on the merits of the contested issues would be inappropriate. Likewise, any attempt to develop an actual rate of return at this time would be futile.

My attention has also been brought to a number of typographical errors in the other schedules attached to my October 19, 1983 letter. Those errors have been corrected, and I am attaching corrected copies. Additionally, the schedules have been revised to note the source of the figures shown. Because of the pendency of the rate case, the figures contained in the revised schedules are subject to contest and change.

I appreciate that you would like more specific information than contained in the materials enclosed. However, to provide such information would require my evaluating the merits of the positions of the parties now arguing the case. I am confident that you understand that I am constrained from making that evaluation, until the case comes before the Commission after the hearing has been completed.

It was certainly not my intention to misinform or mislead you or any other interested party. I trust that the enclosed corrections, the revised schedules and my comments will remedy any misconceptions that may have been formed.

Sincerely,

A. G. SOUSA,
Acting Chairman.

Enclosure.

AMERADA HESS PIPELINE CORP.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	144,985			
Accrued depreciation	15,626			
Net plant [1]	129,359			
2. Operating expenses		13,971	14,429	12,264
3. Interest expenses [2]		6,079	4,568	3,068
4. Debt service cost [3]		11,306	9,820	8,348

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Includes interest costs.

Source: F.E.R.C. Form P (now F.E.R.C. Form 6).

Note: All stated amounts are at issue before a F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78-1.

ARCO PIPE LINE CO.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	1,963,042			
Accrued depreciation	177,311			
Net plant [1]	1,785,731			
2. Operating expenses		198,939	206,672	178,978
3. Interest expenses [2]		129,129	130,390	89,035
4. Debt service cost [3]		157,692	322,997	487,551

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Debt service costs were estimated from information contained in F.E.R.C. Form P (now F.E.R.C. Form 6) and/or annual reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

Source: Alaska Pipeline Commission annual report; Alaska Public Utility Commission annual report.

Note: All stated amounts are at issue before a F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78-1

BP PIPELINES, INC.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	1,498,823			
Accrued depreciation	143,131			
Net plant [1]	1,355,692			
2. Operating expenses		149,867	153,491	138,122
3. Interest expenses [2]		103,330	97,294	92,071
4. Debt service cost [3]		129,232	149,908	144,919

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Includes interest costs.

Source: F.E.R.C. Form P (now F.E.R.C. Form 6)

Note: All stated amounts are at issue before a F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78-1.

EXXON PIPELINE CO.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	1,830,476			
Accrued depreciation	178,826			
Net plant [1]	1,651,650			
2. Operating expenses		182,190	188,745	168,480
3. Interest expenses [2]		111,035	100,468	99,654
4. Debt service cost [3]		270,829	260,110	110,154

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Debt service costs were estimated from information contained in F.E.R.C. Form P (now F.E.R.C. Form 6) and/or annual reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

Source: Alaska Pipeline Commission annual report; Alaska Public Utility Commission Annual report.

Note: All stated amounts are at issue before a F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78–1.

MOBIL ALASKA PIPELINE CO.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	461,469			
Accrued depreciation	45,206			
Net plant [1]	416,263			
2. Operating expenses		45,767	40,110	36,017
3. Interest expenses [2]		28,967	28,863	28,788
4. Debt service cost [3]		28,959	28,950	28,951

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Includes interest costs.

Source: F.E.R.C. Form P (now F.E.R.C. Form 6).

Note: All stated amounts are at issue before a F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78–1.

PHILLIPS ALASKA PIPELINE CORP.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	146,409			
Accrued depreciation	14,811			
Net plant [1]	131,598			
2. Operating expenses		13,353	11,555	9,958
3. Interest expenses [2]		10,066	10,027	9,997
4. Debt service cost [3]		10,364	10,275	10,080

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Includes interest costs.

Source: F.E.R.C. Form P (now F.E.R.C. Form 6).

Note: All stated amounts are at issue before a F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78–1.

SOHIO PIPELINE CO.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	3,181,669			
Accrued depreciation	305,996			
Net plant [1]	2,875,673			
2. Operating expenses		299,052	285,032	269,707
3. Interest expenses [2]		239,655	227,137	215,508
4. Debt service cost [3]		294,543	338,140	327,189

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Debt service costs were estimated from information contained in F.E.R.C. Form P (now F.E.R.C. Form 6) and/or annual reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

Source: Alaska Pipeline Commission annual report; Alaska Public Utility Commission annual report.

Note: All stated amounts are at issue before an F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78-1.

UNION ALASKA PIPELINE CO.

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
1. Total investment [1]	146,106			
Accrued depreciation	14,009			
Net plant [1]	132,097			
2. Operating expenses		13,704	12,388	10,198
3. Interest expenses [2]		8,364	8,053	7,561
4. Debt service cost [3]		8,331	13,689	13,260

[1] Investment includes construction work in progress.
[2] Per income statement.
[3] Includes interest costs.

Source: F.E.R.C. Form P (now F.E.R.C. Form 6).

Note: All stated amounts are at issue before a F.E.R.C. administrative law judge in the pending TAPS rate case, Docket No. OR78-1.

SCHEDULE C.—TRANS ALASKA PIPELINE SYSTEM, INTERSTATE TARIFF RATES

[Per barrel]

Owner company	ICC tariffs [1]	Filed tariffs [2]
Amerada Hess Pipeline Corp.	$4.85	$6.44
ARCO Pipe Line Co. [5]	4.91	6.04
BP Pipelines, Incorporated [5]	4.68	[3] 6.35/5.40
Exxon Pipeline Co.	5.10	[4] 6.27/5.30
Mobil Alaska Pipeline Co.	4.84	6.31
Phillips Alaska Pipeline Corp.	4.83	6.22
Sohio Pipe Line Co.	4.70	6.16
Union Alaska Pipeline Co.	4.89	6.09
Weighted average rate	4.84	6.20

[1] In effect from date of initial service to expiration of the ICC suspension period during January 1978.
[2] In effect subsequent to the ICC suspension period.
[3] BP reduced its rate to $5.40 per barrel from July 1, 1982 to Nov. 1, 1983.
[4] Exxon reduced its rate to $5.30 per barrel from Jan. 1, 1982 to Oct. 19, 1983.
[5] ARCO and BP levy a surcharge for oil originating in the Kuparuk reservoir.

EXXON PIPELINE CO.,
Houston, Tex., November 3, 1983.

Hon. BERKLEY BEDELL,
Chairman, Subcommittee on General Oversight and the Economy, Committee on Small Business, House of Representatives, Washington, D.C.

DEAR CHAIRMAN BEDELL: We have been furnished a copy of the letter you received from the Federal Energy Regulatory Commission responding to your request for information on the carriers operating in the Trans Alaska Pipeline. We reviewed the data furnished you for Exxon Pipeline Company. (Specifically page 3 of Schedule B, Attachment I.) While the information presented was based on testimony filed in the TAPS rate case, the rates of return calculated by FERC Staff using parts of these data are grossly misleading and in some cases, wrong.

We have attached a tabulation of data extracted from Exxon Pipeline's testimony in the rate case. For ease of comparison, we have arranged the format in this Attachment II to correspond to that furnished you by FERC.

In the FERC document the first column purports to be Exxon Pipeline's position and the next two columns the State of Alaska and the FERC Staff positions respectively. Our Attachment II similarly contains the pipeline position in the first column. The second column of Attachment II is a tabulation of data adjusted to conform to the depreciated original cost methodology used by both the State and FERC Staff and is directly comparable to both the second and third columns in the FERC document. You will note the disparities between the two documents.

There are three major reasons that explain why the rates of return calculated by FERC Staff vary so greatly from those calculated by Exxon Pipeline Company.

First, referring to the "rate base claimed" line, the difference shown is a result of two factors. One is the methodology employed. The company position utilizes valuation, the methodology utilized for regulation of oil pipelines for more than 40 years, to determine the appropriate rate base. The State and FERC utilize a depreciated original cost methodology. While this concept has a long history of application in public utility regulation, it has never been utilized in the Federal regulation of common carrier oil pipelines and is completely inappropriate. The second factor that explains this difference in rate base is the arbitrary reduction in the original cost of the pipeline construction reflecting both the State and the Staff's contention that part of the original cost of the pipeline facility should be disallowed ($400 million and $130 million, respectively) as imprudently incurred. It should be noted that the Commission in its Williams decision did affirm valuation as the proper rate base for oil pipelines generally, but the issues of methodology (valuation versus depreciated original cost) and imprudent investment have not been decided. It is presumptuous of the Staff to decide these issues for themselves.

The other major reason for the difference in calculated rates of return is that the Staff simply made an error in not recomputing the "income taxes claimed" for the cases displayed in columns two and three in the FERC document.

While there are numerous other factors that could account for differences in rate of return calculations, these three are the most significant and certainly the most obvious.

We appreciate your concern that just and reasonable tariffs be determined for the TAPS carriers. We believe that Exxon Pipeline Company's rates reflect a fair rate of return on the value of its investment in TAPS and particularly so in view of the risks attendant to what has been described as one of the greatest construction projects ever undertaken by private industry.

Should you desire to pursue the issues raised in the FERC letter in more detail, I and appropriate members of Exxon Pipeline's staff would be happy to meet with you and your staff at your convenience.

Enclosures.

Sincerely,

KENNETH P. FOUNTAIN.

EXXON PIPELINE CO.—RATE OF RETURN

	Company position	State of Alaska position	FERC staff position
1980:			
Revenues	$696,124	$696,124	$696,124
Operating expenses	170,098	153,413	157,186

EXXON PIPELINE CO.—RATE OF RETURN—Continued

	Company position	State of Alaska position	FERC staff position
Income taxes claimed	217,946	28,426	51,262
Carrier income	308,080	514,285	487,676
Rate base claimed	1,879,600	1,157,602	1,360,043
Rate of return (percent)	16.39	44.43	35.86
1981:			
Revenues	695,997	695,997	695,997
Operating expenses	175,465	157,051	161,701
Income taxes claimed	231,695	50,442	56,286
Carrier income	288,846	488,504	478,010
Rate base claimed	1,842,510	1,115,888	1,296,687
Rate of return (percent)	15.68	43.78	36.86
1982:			
Revenues	633,512	633,512	633,512
Operating expenses	170,069	137,985	142,492
Income taxes claimed	215,950	15,883	36,711
Carrier income	247,493	479,644	454,309
Rate base claimed	2,081,591	1,049,663	1,225,627
Rate of return (percent)	11.89	45.70	37.07

EXXON PIPELINE CO.

[Dollars in thousands]

	Valuation methodology [1]	Original cost methodology [2]
1980:		
Revenues	696,124	696,124
Operating expenses	170,099	179,890
Income taxes	215,950	243,476
Carrier income	310,075	272,758
Rate base	2,044,456	1,719,061
Rate of return (percent)	15.2	15.9
1981:		
Revenues	695,997	695,997
Operating expenses	175,455	185,371
Income taxes	222,322	247,381
Carrier income	298,220	263,245
Rate base	2,108,825	1,588,292
Rate of return (percent)	14.1	16.6
1982:		
Revenues	633,512	633,512
Operating expenses	164,281	171,239
Income taxes	198,364	223,178
Carrier income	270,867	239,095
Rate base	2,158,777	1,503,268
Rate of return (percent)	12.5	15.9

[1] Exhibits SAF–2 and SAF–3.
[2] Exhibit SAF–5.

Source: Prepared direct testimony of Samuel A. Flint on methodology and rate of return—Aug. 1, 1983 and supplemental revisions.

EXXON COMPANY, U.S.A.,
Houston, Tex., September 28, 1983.

Hon. BERKLEY W. BEDELL,
U.S. House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE BEDELL: During your recent Subcommittee hearings on Alaskan North Slope (ANS) windfall profit tax payments, Mr. Edward G. Modell of the Independent Gasoline Marketers Council stated that the Trans Alaska Pipeline System (TAPS) owners had a three to four year payout on their investment. Although there was no explanation of this statement, it would appear that it was based on one year's gross revenue calculated from tariffs and throughput divided into the total $9.5 billion investment.

Although we can't speak for TAPS overall, we would like to clarify for the record the situation regarding our share of the pipeline. Exxon Pipeline Company owns approximately 20 percent of TAPS and operates it as a separate common carrier. Based on an initial investment of $1.8 billion and considering 1982 new cash flow (gross revenue-operating costs including taxes), it would take more than seven years for net cash flow to equal the original TAPS investment. When the time lag from the initial phases of construction to startup is included, the period is extended to over ten years.

When viewed in the proper perspective, we believe the tariffs being charged for the TAPS are reasonable and a proper basis for inclusion in the ANA netback calculation.

Sincerely,

ROBERT J. DOYLE.

CONNOLE & O'CONNELL,
Washington, D.C., November 7, 1983.

Hon. A. G. SOUSA,
Acting Chairman, Federal Energy Regulatory Commission,
Washington, D.C.

DEAR CHAIRMAN SOUSA: BP Pipelines Inc. has recently received a copy of your letter of October 19, 1983 to Congressman Berkley Bedell providing financial data on the TAPS carriers. On behalf of BP Pipelines, we wish to submit these comments. We believe the material furnished contains inaccurate and misleading information and we are concerned that Rep. Bedell and his subcommittee might rely on this material in taking positions with respect to oil pipeline regulation.

The position of the State of Alaska on BP Pipelines' rate of return as set forth on page 2 of Schedule B to your letter is grossly misstated. The analysis combines those amounts derived by the State in presenting its desired tariff results, with the amounts of BP Pipelines' actual operating revenues, thereby producing a misleading mismatch. The most obvious example is in the income taxes claimed. The State of Alaska has recognized that federal and state income tax liability is in excess of 46 percent of revenues less expenses. Yet, the amounts shown on Schedule B for BP Pipelines range from a negative to a maximum of 3.25 percent. The analysis fails to recognize that the State's calculation of tax liabilities are those associated with their proposed rates and revenues, not actual revenues. It is incorrect to deduct the State's $25 million tax liability for 1980 (your report shows $6.181 million) from actual revenue of $556 million, when the $25 million was calculated using a revenue of only $255 million. In your calculation, the claimed net earnings are nearly twice actual earnings for each year. The resulting ratios of return to rate base are grossly overstated, even assuming the State's understated expenses and investments were correct.

The amounts for operating expenses shown as the State's claim assume that the State would totally prevail in its efforts to reduce BP Pipelines' tariff; the State witnesses have already agreed on the witness stand that some of their adjustments should be withdrawn and that other adjustments will be reconsidered. In addition, the amount shown as the State's rate based reflects its proposed disallowance of more than $2 billion from actual investment in the pipeline, a position of considerable controversy.

In addition to the foregoing errors in calculation, there are also errors on Schedule A, page 3, which include:

Total Investment on 1/1/80, including C.W.I.P., shown on BP's Form P filed with the FERC was $1,498,823, not $1,491,538, which includes only depreciable property.

The accrued depreciation reported for 1/1/80 was $143,130,000 not the $156,610,000 shown on Schedule A.

Reported operating expenses for 1981 were $153,491,000, not $15,349 as shown on Schedule A.

The Company's rate base for 1980 claimed on Schedule B page 2 should be $1,607,086 rather than $607,086.

We feel it is only appropriate to correct the information supplied to Congressman Bedell and we earnestly request that this be done. If you or your staff have questions concerning our views, please let us know. We would be happy to clarify them.

Respectfully yours,

QUINN O'CONNELL,
Attorney for BP Pipelines, Inc.

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APPENDIX D.—ADDITIONAL MATERIAL SUPPLIED BY ARCO

AtlanticRichfieldCompany Legal
515 South Flower Street
Mailing Address: Box 2679 - T. A.
Los Angeles, California 90051
Telephone 213 486 2452

Richard C. Morse
General Attorney

October 17, 1983

The Honorable Berkley Bedell
Chairman
Subcommittee on General Oversight
and the Economy
U.S. House of Representatives
Washington, D.C. 20515

Attention: Ms. Nancy Szabo:

I enclose the portion of the transcript which contains Mr. Kowal's remarks before the Oversight and Economy Subcommittee at its September 15, 1983 hearing to consider the effects, if any, on competition in the retail gasoline marketplace caused by Internal Revenue Service Ruling 83-124.

In addition, I submit these supplemental comments for the record in an effort to more clearly state the salient points which may have been less than clear in the transcript.

Atlantic Richfield's specific response to the question of whether Ruling 83-124 has had any effect on competition in the retail gasoline marketplace is that there has been none. This response is premised upon the fact that, so far as we know, none of the major producers of Alaska North Slope crude changed its pricing practices or valuation methodology for that crude oil for purposes of calculating its Windfall Profits Tax liability. Thus, there was no consequence or effect on competition which could be attributed to that Ruling.

Recognizing that this response may be more narrow than the underlying concern with respect to the apparent disparity in methods of valuing Alaska North Slope crude oil, a more general response is appropriate. There is no question but that the raw material costs of any manufacturer, including a refiner, have an influence upon prices in the marketplace. If there has been a general increase in the cost of raw materials, then eventually the competitive environment will recognize that fact and manufactured products should rise in price. Over the long term, product prices must rise, raw material costs must go down, or eventually those manufacturers would go out of business. In the short term, however, there usually are myriad competitive factors which can cause some lag before product prices rise in response to raw material cost increases. Those factors include: 1) the level of inventories produced at the lower raw material cost; 2) whether product is in long or short supply; 3) and most importantly, whether competitors have increased their prices for the manufactured products.

In the case of motor gasoline, in the fall of 1983 there was, and continues to be, nearly record high levels of inventory. Demand continues to be significantly below the level of demand when high inventory records were set; and the consequent competition is intense.

Thus, while it is true that a crude cost increase, whether resulting from price changes or tax changes, may eventually affect product prices, ARCO has priced its gasoline at levels intended to enable its dealers and distributors to remain competitive with their competition. It is in that context that we submitted to the Subcommittee that the cost of crude oil was not the immediate determining factor in the establishment of ARCO's gasoline prices.

While we appreciate that many members of the Subcommittee had heard our description of the ways in which we had made our refineries and supply system differentially efficient when compared to our competition, we repeated that description in the September 15 hearing for two reasons which we believed to be relevant to the concerns of the Subcommittee:

1. Because we believe that we are more efficient than our competition, we have adopted a policy of meeting our competitors' prices.

2. In the criticism voiced over the past year, including the testimony of those witnesses preceding Mr. Kowal at the September 15 hearing, the common theme has been that the only explanation for ARCO's gasoline prices must be its "crude oil cost advantage" derived from its method of valuing Alaska North Slope crude oil. We repeated the description of our efficiencies because we believe it to be the correct explanation of our ability to compete with other suppliers.

The allegation presented by earlier witnesses was that: ARCO's method of valuing Alaska North Slope crude oil gives it a two or three dollar per barrel cost advantage versus its competitors. That is simply not true.

First, "posted prices" for crude oil are the prices at which refiners obtain the vast majority of their raw material supply. Those prices represent ongoing, long term relationships between buyers and sellers. By contrast, "spot" prices reported by "Platt's Oilgram," and used by a witness at the September 15 hearing reflect the prices of, at most, ten percent of the crude oil purchased by refiners. A "Spot" quote often involves a single transaction, or even an unconsummated offer to buy or sell, much like the prices quoted in the over-the-counter stock market.

Therefore, posted prices are the prices relevant to analyses of refiners' costs of crude oil, and the values for calculations of tax liability.

West Texas Sour is a crude type produced in large volumes by a multitude of producers and purchased by many refiners. In the second quarter of 1983, its posted price was $29.00 per barrel. At the same time, a comparable California crude, Buena Vista, was posted at $24.25 per barrel. (Both adjusted to 27^0 API gravity.)

The difference between the posted prices of crude oil comparable to Alaska North Slope crude in California and Texas, $4.75 per barrel, is representative of the difference in cost of transportation, and is far more probative than the $1.40 differential derived by a comparison of "spot" and "posted" prices which was presented by a witness at the hearing.

Atlantic Richfield has no advantage over its competitors because its California competitors buy over 1.1 million barrels per day of California crudes at prices comparable to the $24.25 posting, and ARCO's cost of Alaska North Slope was almost identical ($24.48 in October, 1983.) Similarly, in the Texas Gulf Coast, ARCO's cost of ANS is, by definition, identical to West Texas sour, because that crude sets the value of ARCO's ANS. Therefore, ARCO has no crude cost advantage over its competitors in either refining center.

Secondly, if a "tax savings" could be ascribed to ARCO's method of valuation for calculating Windfall Profits Taxes, it would not be $2.00 per barrel, nor 5 cents per gallon. Windfall Profits Tax liability is calculated based upon the North Slope "removal prices". As the enclosed "ARTA Energy Insights" analysis shows, at Table 2, ARCO's "wellhead prices" have sometimes been higher, and only in the third quarter of 1983 were they more than $2.00 less than the highest removal price. In 1983, ARCO's removal price was higher in the 1st quarter, and slightly more than 1 cent per gallon less than Sohio's in the 2nd quarter.

From 1982 through the 2nd quarter of 1983, ARCO's valuation of ANS for WPT calculations resulted in an average WPT payment of $0.00821 per gallon less than Sohio; and $0.00694 less than Exxon.

Windfall Profits Tax Per Gallon (More/Less) By ARCO vs. Sohio and Exxon*

Quarter	¢/gal.	¢/gal.
1982.1	$0.0172 more	$0.0115 more
2	$0.013 less	$0.0053 less
3	$0.046 less	$0.0135 less
4	$0.0218 less	$0.0158 less
1983.1	$0.0017 more	$0.0145 more
2	$0.0092 less	$0.004 less
Average	$0.00821 less	$0.00694 less

*"Tax Savings" equals WPT rate of 70% of differences in wellhead prices from table 2, page 3, "ARTA Energy Insights," "ARCO AND ITS CRITICS," converted to cents per 42 gallon barrel.

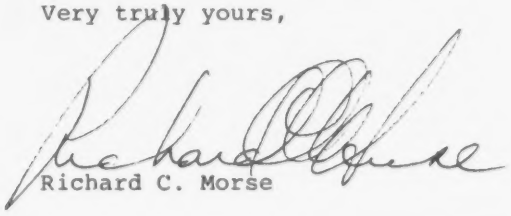
In conclusion, Ruling 83-124 has had no effect on retail competition because we are unaware that any major producer of Alaska North Slope crude has changed its valuation methods in response to that Ruling. Secondly, that Ruling has had no effect upon Atlantic Richfield's prices of gasoline inasmuch as Atlantic Richfield has priced and continues to price its gasoline based upon prices offered by competing refiners; and the various methods of calculating removal prices for Alaska North Slope crude oil do not provide Atlantic Richfield with a crude oil cost advantage versus its competitors because the price it pays for crude oil and the price upon which it calculates Windfall Profits Taxes are equal to the prices paid for crude oil by its competitors.

I enclose a copy of "ARCO AND ITS CRITICS," published in "ARTA Energy Insights," Summer 1983, as an insightful discussion of the issues. While Atlantic Richfield does not necessarily subscribe to all of the views expressed, it is a reasoned description of the problems.

I hope that this supplement has clarified Atlantic Richfield's views expressed at the September 15, 1983 hearing of the Subcommittee. If you have any questions with respect to any of the matters discussed, we would be pleased to provide further information or amplification.

In accordance with your letter of September 30, 1983, this separate, signed letter is submitted for inclusion in the record.

Very truly yours,



Richard C. Morse

RCM/m

Encls. 1. Corrected transcript of J.D. Kowal
2. "ARTA Energy Insights," "ARCO AND ITS CRITICS."

ARTA ENERGY INSIGHTS
Pacific Oil Insights

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Number 1 Summer 1983

ARCO AND ITS CRITICS:
The North Slope Crude-Oil Transfer-Price Controversy

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ARCO AND ITS CRITICS
The North Slope Crude-Oil Transfer-Price Controversy

I. INTRODUCTION

One year ago, the Atlantic Richfield Company (Arco) startled the petroleum industry by cancelling its credit cards, a decision that defied conventional wisdom about petroleum marketing. As a decade of shortages and rising prices gave way to surpluses and renewed price competition, most insiders regarded customer–dealer loyalty as the key to retaining market shares and stable profits. Experienced petroleum marketers chuckled as Arco set about to give away a big chunk of its established market to its competitors.

It Arco's decision seemed rash at best in April of 1982, the view abruptly shifted in a few short months as the company's strategy turned out to be a stunning success. While the nation's average refinery-utilization rate tumbled to 60 percent and below, Arco was running its refineries at 95 to 100 percent and negotiating for more capacity. Standard Oil of California (Chevron), which historically has had the largest market share on the West Coast, began offering discounts similar to Arco's. The result was a dramatic slide in retail gasoline prices across the country, but particularly on the West Coast.

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The belated but vigorous reaction of other refiners to Arco's campaign for a larger market share was soon followed by a less than flattering analysis of the cause for its success. Independent marketers and others began to suggest that the credit-card cancellation was nothing but screen behind which Arco was underpricing the Alaska North Slope (ANS) crude oil it transfered to its refineries, thereby avoiding the federal Windfall Profit Tax, as well as taxes and royalties properly due the State of Alaska. Using this scheme, they complained, Arco could acquire crude oil cheaper than any other refiner, making it possible to underprice its competitors and still reap a huge profit.

The gasoline-price war in the spring of 1983 and the debate over Arco's ANS transfer-pricing method have drawn attention to the overall level and structure of prices in PAD District V (California, Arizona, Nevada, Oregon, Washington, Alaska, and Hawaii). It has sparked IRS and Congressinal investigations of allegations that Alaska and California crude prices are too low, and spawned at least one anti-trust suit.[1] At nearly the same time, ironically, the Federal Trade Commission (FTC), has raised questions about Sohio's domination of the West Coast crude-oil market, suggesting that ANS crude oil may have been priced too high. While the FTC approved the Department of Interior's recent Beaufort Sea lease sale to Sohio and others, one Commissioner dissented, charging that, Sohio ". . . has exploited its dominant position in the past."[2]

Something is really different about West Coast energy pricing. Despite the angry tenor of the debate, there is a common thread: the industry is confused; federal and state policies are confused; and the consumer is equally confused.

II. ARCO'S GASOLINE-MARKETING STRATEGY

Arco has replied to its critics with an innocence that borders on sanctimoniousness, that its recent success was due to its refinery modernization program and a superior marketing strategy, not to a crude-oil price advantage.[3] At the same time, perhaps because of the siege of Congressional hearings, lawsuits, and threats of lawsuits, Arco has been remarkably open about that marketing strategy.

Old hands in the retail gasoline business used to say there were three main ways to compete: lower prices, longer hours, and the attractiveness of the service station. In the mid 1970s Arco embarked on a program designed to roll together all three advantages. Arco began by attaching convenience food stores to its filling stations and by eliminating auto repairs. This program naturally entailed a general physical upgrading of Arco service stations. At the same time the economics of convenience-store marketing required long and odd hours. To make any money the dealers had to keep the store and the gasoline pumps open at least until midnight. By eliminating auto repairs, Arco got its dealers to focus on Arco's main goal, gasoline sales. This approach made it both possible and necessary to pump a high volume of gasoline each month.

At the same time that Arco revamped its retail gasoline sales network, it modernized its refineries to utilize lower-quality crude oil and make a higher percentage of gasoline. These moves made double sense: the backbone of Arco's crude-oil supply was lower quality oil from Alaska. Moreover, conservation and fuel-switching consequent on higher petroleum prices since the 1970's has steadily undermined heavy fuel-oil (HFO) sales.

Thus, in early 1982 Arco was poised to launch the final and most important part of its strategy—fierce price competition for a larger market share. The first step was to eliminate credit cards. This action did cut some costs, but more importantly it established a high public profile for the most aggressive price-cutting campaign in a decade. During 1982 Arco's market share increased 24 percent to 4.79 percent of the national market, and most of this increase was achieved in the West.[4] Even more dramatically, by March 1983, the average throughput of Arco's stations had increased to 125 thousand gallons per month, over two and one-half times the industry average.[5]

For the moment (August 1983), the price war for market shares is in remission: the summer driving season has increased the demand for gasoline and Arco has reached the limits of its crude-oil availability and refinery capacity. But, the strategy has left its mark: it has drawn attention to the practice of transfer pricing among integrated firms and to the peculiarities of petroleum-product and crude-oil pricing in PAD District V.

Other companies and associations were highly critical of Arco in March and April, when the price war was at its height. They stated that Arco's competitive advantage was not due to its superior marketing strategy, but, rather to a scheme for avoiding the windfall profits tax on ANS crude oil. According to its critics, Arco's scheme was simple. Sohio has

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no refineries on the West Coast and Exxon has only one. Thus, if these companies wish to dispose of ANS crude oil on the West Coast, they must sell or exchange it. On the other hand, Arco has a large West Coast refinery and marketing operation, and has no need to sell ANS crude oil to others. Instead Arco transfers it to its own refineries.

In contrast to the case of most Lower-48 crude oils, there is not a posted price for ANS crude. Instead the companies in most cases sell or transfer the crude to themselves at pump station No. 1 of the Trans Alaska pipeline (TAPS), and resell it or exchange it to other parties somewhere downstream from Alaska, if at all. From this downstream price, they deduct pipeline and tanker charges and report a "netback" wellhead price to the State of Alaska for tax and royalty purposes. If the oil is valued at the wellhead above the windfall-profits-tax base price, the "first purchaser" of the oil (generally the producing company itself) is required to pay the Treasury 70 percent of the difference.

Since Arco does not normally sell ANS crude oil in PAD District V, the company had to develop a system for computing its transfer value. Arco's scheme has a simple logic. The value of ANS crude oil to Arco at Valdez (the outlet of TAPS) is the price it would command on the U.S. Gulf Coast, less the transportation cost of moving the crude through Panama. The value of Arco's refineries in California or Washington is this imputed Valdez price plus tanker charges from Valdez to the refinery. Using this methodology, Arco was able to transfer ANS crude to its refineries for several dollars less than other refiners could buy it from Sohio or Exxon. This, of course, is the approach which led to the allegations of tax-evasion and unfair competition.

From the standpoint of the textbook theory of competitive markets, Arco's general pricing methodology is unassailable. (See the appendix to this report, *The Simple Economics of Competitive Crude-Oil Pricing in PAD District V.*) As a result of the higher shipping cost to the Gulf and East Coasts, there is an incentive for ANS producers to discount crude-oil prices in order to sell additional volumes on the West Coast and avoid the extra shipping charge. As James C. Morrison, President of Arco's products–marketing subsidiary, put it in one of the Congressional Hearings: "Because of this excess supply of crude oil available, the West Coast is a buyer's market. There is more supply there than is needed by users. In a buyer's market, a commodity's price will reach the equilibrium with the same commodity's value in the next alternative market. This is the case for indigenous West Coast crude, where posted prices for that West Coast crude produced in California are equivalent to the comparable prices of crude oils in the Gulf Coast after adjusting for transportation."*

Table 1
California and Gulf Coast Crude Oil Prices, 1982–83
(Dollars per Barrel)

Quarter	Calif. Buena Vista*	West Texas sour	North Slope spot
1982 I	27.92	33.00	29.64
1962 II	26.25	31.00	32.69
1982 III	26.25	31.00	32.69
1982 IV	26.25	31.67	31.35
1983 I	25.58	29.67	27.52
1983 II	24.25	29.00	29.19

*Adjusted to API 27°.
Source: *Platt's Oilgram Price Report*

Arco is also right in principle about California crude-oil prices: they have been consistently below their counterparts in the Gulf Coast, as evidenced by table 1. It is important to recognize, also, that Arco's North slope wellhead prices have not in fact been significantly, or consistently, lower than those of Sohio or Exxon. As table 2 shows, Arco's netback prices were in fact the highest of the three during the early months of 1983, when the District V gasoline-price war was at its height. Arco's critics are demanding, in effect, that Arco's transfer price remains higher than those of other ANS producers (as it was until the Spring of 1982), because of the company's ability to process its own crude oil in its own West Coast refineries.

Table 2
North Slope Wellhead Prices, 1982–83
(Dollars per Barrel)

Quarter	Arco	Sohio	Exxon	Arco v Sohio	Arco v Exxon
1982 I	20.45	19.42	19.76	+1.03	+.69
1982 II	18.75	19.53	19.07	−.78	−.32
1982 III	18.43	21.20	19.24	−2.77	−.81
1982 IV	18.95	20.26	19.90	−1.31	−.95
1983 I	17.92	17.82	17.05	+.10	+.87
1983 II	17.02	17.57	17.26	−.55	−.24

Source: Salomon Brothers from company data

If there is any mystery about ANS prices it is rather, as Arco suggests, the length of time that Sohio's and Exxon's netback prices at Prudhoe Bay were higher for ANS oil sold to other companies on the West Coast than for the oil they shipped *via* Pan-

ama to refineries farther East. Within this mystery, there nevertheless remains another puzzle that leaves Arco's critics with one respectable complaint. Apparently Arco has been the only West Coast refiner able to take full advantage of its low crude-oil prices. Through the price-wars of early 1983, this situation left everyone else either buying very expensive imported crude oil, ANS from Exxon and Sohio at prices considerably higher than those at which Arco was transferring equivalent oil to its own refineries, or California crude—which is mostly heavier, higher in sulfur, and consequently more expensive to process and, moreover, available primarily on the basis of long-term contracts.

The region's independent refiners have alleged that Arco and other Major oil companies have cut gasoline and other product prices, but that these reductions were not accompanied by reductions in the prices of those categories of crude oil usable by and available to the independents. In words of Jack Blum, General Counsel of the Independent Gasoline Marketers Council: "In the face of Arco's onslaught in the product market, the price of crude has held . . . In plain English, we don't believe that the price of crude can stay above the price of product for months on end unless the major producing companies are working together to maintain the price. In a competitive market, the price of crude would have to drop."[7]

This criticism is not entirely without merit. Unless Arco is willing to sell sufficient ANS crude oil at arms' length to competing West Coast refiners to force the other North Slope producers to market their ANS crude in District V at Arco's transfer price, that transfer price will remain something other than the "true" market value of the oil and will, as a result, remain suspect.

The data clearly reveal, nonetheless, that the prices of all crude oils produced in PAD District V have fallen (even if not to the level predicted by the competitive-pricing model), and prices there are now consistently much lower than for comparable grades East of the Rockies. Sohio and Exxon, as well as Arco, are selling ANS crude oil in District V at lower prices than on the Gulf Coast. An additional problem for those refiners who do not have their own ANS production, however, is that West Coast petroleum-product markets, particularly those for gasoline, have developed exaggerated seasonal swings in price. And thus far, crude-oil price movements have not mirrored the seasonal movements of product prices. Moreover, the period of fierce competition in petroleum markets accompanied a period in which official OPEC prices for imported crude oil were much higher than domestic spot-market prices. Since the West Coast does not have a continuous, efficient spot market for crude oil, the high cost of imports made crude-short refiners there willing (however unhappily) to pay a short-term premium to obtain ANS crude.

It is the seasonal swing in product product prices that creates the most acute problem for the independent refinery sector. Broadly speaking, the West Coast import gasoline and exports heavy fuel oil. Independent refineries in California, Alaska, Hawaii and Washington are far less complex than the ones operated by the major oil companies in PAD District V. They have little or no ability to reprocess high-sulfur residual oil into gasoline, and as a consequence depend on imports of light, sweet crude oils, which District V produces in only small quantities. Thus, California crude-oil price declines did not help the independents, who were stuck with imported crude or higher priced ANS.

However, it is the independent refiners that supply the incremental amounts of gasoline needed during the West Coast's peak driving season. They help hold prices down in the summer, but are at the mercy of a buyer's market in the winter. In effect, the profitability of independent refineries has developed seasonal swings that mirror the swings in petroleum-product markets, to which they have not yet been able to adapt.

Table 3
Average Wholesale Gasoline Prices, 1982–83
(Cents per Gallon)

Quarter	Los Angeles	Seattle	Houston	New York
1982.I	93.10	97.08	92.16	97.80
1982.II	94.04	93.28	92.35	94.07
1982.III	99.96	99.77	96.47	97.88
1982.IV	90.13	93.55	90.85	94.42
1983.I	78.21	77.36	81.90	87.35
1983.II	86.24	79.51	88.20	92.25

Source: *Platt's Oilgram Price Report*

Another level of complexity is added by regional differences within PAD District V. In the first half of 1983, Oregon and Washington replaced Texas as the states with the lowest gasoline prices, in part because Puget Sound is the closest refinery center to Alaska. The Pacific Northwest also became the battleground for this spring's gasoline price wars because of the seasonality of its demand. The comparatively great weight of their tourist industries lead Oregon and Washington to consume much more gasoline in the summer than in the winter. As a result, the Puget Sound Refineries ship gasoline to California in the winter, making them very price-competitive in their home market.

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While Arco's general theory regarding the price of ANS crude oil is unquestionably correct, the complexity of PAD District V refinery configuration, turbulent prices, the seasonality of product demand and, not least, the difficulty of fixing the "true" cost of tanker transportation between Valdez and Lower-48 refineries, make it difficult to determine whether Arco's specific ANS transfer prices are reasonable. That judgment requires a more in-depth analysis of ANS wellhead prices than we have attempted in the present report.

III. EROSION OF THE TWO-PRICE SYSTEM FOR ANS CRUDE OIL

In the Fall of 1982, the Department of the Interior held what may be its most important oil and gas lease auction of this decade. 125 offshore tracts in the Beaufort Sea were sold for about $2 billion.[8] Just as Sohio dominates Alaska and West Coast crude-oil markets with more than 600 thousand barrels (Mb/d) per day of net production from Prudhoe Bay, it also appeared to dominate lease sale 71. Twenty-one of the highest-priced tracts fetched more than $1.5 billion. In six of these Sohio (with varying partners) was the high bidder.[9]

Sohio's prominence in the lease sale caused the FTC to analyze the sale for its competitive implications. In the Commission's report to the Anti-Trust Division of the Department of Justice, the majority decided that the sale did not present a serious anti-competitive problem, primarily because of uncertainty about the amount of reserves to be discovered, the economics of their recovery, and future levels of oil demand and supply in PAD District V.

The Commission did, however, summarize (and implicitly reaffirm) its earlier position, that "... in the late 1970's the dominant producers of Alaskan North Slope Crude appear to have recognized that they could achieve higher prices (and, presumably, higher profits) by limiting West Coast sales of such oil."[10] As a result of the willingness of North Slope producers to ship surplus ANS crude oil beyond the West Coast despite the lower netback price, a two-price system emerged for ANS crude oil.

Normally there is a single wellhead price posted for each grade of crude oil in any field, because almost all crude-oil producers are "price takers." Despite the absolute size of the oil industry, the shares of individual companies, even in particular producing regions, tend to be low. And unless the firms producing the crude oil are fully integrated within the region, they have little or no opportunity (or concern, for that matter) to dictate the markets to which their crude will be sent. Even Saudi Arabia, the world's largest oil producer, has not been able to discriminate effectively among buyers, except briefly during periods of market disruption. The Saudis can, within a range, have a powerful influence over the overall world price for crude oil, but they cannot effectively discriminate between, say, European and American buyers, charging them different prices.

In its letter to the Justice Department, the FTC correctly noted that, "A truly competitive supplier would be indifferent to the destination of ANS because the wellhead profit or 'netback' would be equal for each destination."[11] In other words, if there were a large number of oil producers on the West Coast, none of which could unilaterally determine the volume of District V crude shipped out of the region, each of them would individually find it profitable to market their crude where they received the largest net payment after paying processing and shipment costs. If an additional barrel of ANS crude oil could be shipped from Valdez to Los Angeles for $1 and sold there for $27, for example, rather than shipped to the Gulf Coast at a tanker charge of $4 and sold there at parity with imported crude oil at $29, a competitive supplier would choose the first option because it results in the higher netback value ($26 *versus* $25 at Valdez). But, if there were a regional crude-oil surplus, and all of the crude-oil suppliers tried to market their crude oil in the more lucrative Los Angeles market, they would bid the price there down to $26 ($25 at Valdez)—a level at which each shipper would be indifferent to the market in which the crude was sold.

On the other hand, if there were a regional crude-oil surplus deficiency, refiners in Los Angeles would be willing to pay a higher price reflecting the least-cost alternative, namely imported crude oil at $29. In those circumstances, any PAD District V crude-oil producer would be foolish to market crude anywhere other than the West Coast. Whatever the circumstances, therefore, a crude-oil supply surplus or a deficit, this competitive bidding would result in a single wellhead price for each grade of crude oil, as long as the market was in competitive equilibrium.

The same simple economics of competitive pricing is exemplified by crude oil and petroleum-product pricing in Texas and New England. Gasoline and diesel-fuel prices are lower in Houston than in Boston, because Texas produces a surplus of crude oil and New England must rely on imports. Despite these differences between New England and Texas prices which stem from transportation costs, in normal circumstances there is a single price for each grade of crude oil and each type of refined product in each of these markets. If there were not, the differentials would encourage "arbitrage" between

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two areas, with a movement of crude oil or product until a single price for each commodity prevailed in each market.

The two-price system did in fact come into existence, as the FTC hypothesis implies, only because the market for ANS crude oil was not effectively competitive, and it continues to exist today only because intensified price competition since 1981 has not yet fully squeezed out the abnormal price differentials created in the absence of effective competition during the first three years of ANS production. The fact that Sohio's net production exceeded the PAD District V crude-oil "surplus" meant that Sohio alone determined the level of crude-oil prices on the West Coast, whether it wanted to or not, by deciding how to divide its own production between District V and Gulf Coast markets. Under these circumstances, it would have been surprising indeed if Sohio had chosen to compete so aggressively for District V sales that its own, and everyone else's, ANS netback price from the West Coast was driven down to the level it would reach in a perfectly competitive market, namely, equality with the Gulf Coast netback.

Table 4
West and Gulf Coast Delivered Prices of ANS Crude Oil
(Dollars per Barrel)

	West Coast		Gulf Coast	
	Average	Sohio	Average	Sohio
1981	31.83	32.61	33.61	33.64
1982	28.02	29.02	29.80	29.88
1983*	25.75	26.50	27.00	27.00

Source: *Petroleum Intelligence Weekly* (PIW), June 13, 1983.
*ANS prices are now (August) higher than indicated by PIW.

Table 4 shows the average price of crude oil sold in the West and Gulf Coasts. Since the shipping cost is around $4.00 more per barrel to the Gulf Coast, it is immediately apparent that the netback price of ANS sold on the West Coast has been significantly higher, particularly for Sohio. There are two possible explanations for the continued existence of multiple wellhead prices for ANS crude oil in 1983. Either Sohio and the other North Slope producers have cooperated, as the FTC analysis implies, in an exercise of market power to perpetuate an imperfectly competitive pricing structure, or the West Coast market has been in competitive disequilibrium since 1979.

The radical fluctuations shown by table 2 in the relationship among the prices established by the three main ANS producers make it hard to believe that the producers are now colluding, either openly or tacitly, to maintain ANS prices above competitive levels. The notion that District V markets have been continuously out of balance is intuitively much more credible. In the last four years, the oil market in general and the West Coast oil market in particular, have undergone several big shocks. Since 1977, North Slope crude-oil production has built up rapidly from nothing to 1.6 million barrels per day. California production was also increasing (albeit by a substantially smaller amount). At the same time, the oil price explosion of 1979–80 and a delayed response to the 1973–74 upheaval were causing product demand to shrink.

In the space of five years, the West Coast has thus shifted from a region importing more than half a million barrels per day to one exporting eight or nine-hundred thousand. This period has also been one in which the appearance of a worldwide oil shortage has given way to the reality of a worldwide glut. Accordingly, the existence of a somewhat "abnormal" pricing regime for crude-oil in PAD District V would not be startling.

Complicating the special circumstances of District V oil production and consumption have been the special treatment of ANS crude oil under the federal price-control and entitlements system prior to 1981, the effects of oil-price deregulation, and the Windfall Profits Tax which went into effect as price controls were phased out. Between mid-1979 (when the market value of ANS crude oil first exceeded the federal ceiling price) and oil-price deregulation in early 1981, that ceiling price effectively made the producers indifferent to the destination of price-controlled oil, as any added transportation cost beyond the West Coast was subsidized out of the national oil-price "entitlements" pool.

As price controls were phased out in 1980, the WPT was phased in; the combination of royalties, severance taxes, WPT, and federal and state income taxes now absorbs about nine-tenths of any enhancement (or reduction) of netback values at the wellhead. These circumstances have severely diminished the incentive the ANS producers otherwise would have to choose those destination markets, transportation arrangements, and accounting conventions which would have maximized wellhead prices. (It is therefore the federal government and the State of Alaska, rather than the oil companies, which have the biggest financial stake in a high wellhead-price level.) Finally, federal law further frustrates those market forces that would press in the direction of higher netback prices, by prohibiting the ANS producers from exporting their surplus oil (relative to West Coast refinery demand) to its natural

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markets in East Asia, and from using cheaper foreign tankers.

The dramatic shifts in West Coast oil production and consumption and the regulatory upheavals have thus kept District V markets in turmoil, while the WPT and the ANS export ban have maintained pressures and incentives for the producers to depart from economically optimum transportation and marketing programs. One result has been the two-tier pricing system for ANS crude oil which, because it existed continuously from the beginning of ANS production, came to be viewed as normal. Thus, when Arco began to transfer ANS to its West Coast refineries at prices below those quoted for sale by other North Slope producers, it is not surprising that a major controversy emerged.

IV. THE TRANSITION IN DISTRICT V

Oil-producing regions and petroleum markets in most of the United States are interconnected by a pipeline network that allows the inexpensive and rapid flow of fuel wherever it is needed. There is one important exception: despite years of study and public hearings there is no large-capacity East–West pipeline with a terminus on the West Coast. As a consequence, the petroleum markets of PAD District V are effectively isolated from the rest of the United States.

Until ANS crude-oil production reached the capacity of the Trans Alaska pipeline (TAPS), the West Coast consumed more oil than it produced. In 1978 the District produced 2.2 MMb/d of crude oil and consumed 2.6 MMb/d of product. During this period, crude-oil prices in PAD District V were at about the same level as in other U.S. regions because all regions were net oil importers, and because tanker costs from the Middle East to U.S. tidewater refineries were essentially the same on all three coasts. However, as ANS production built up and West Coast consumption declined (because of the 1979 price explosion) the region went from deficit to surplus.

The West Coast now produces about 2.8 million barrels per day (MMB/d) of crude oil and consumes an average of about 2.0 MMb/d of petroleum products. Thus, in the present market circumstances, the region will have to ship an average of about .8 MMb/d of crude oil to Eastern markets. In practice, actual shipments are somewhat higher because of the need to import some high-grade crude oil that is not available from local production. When the surplus appeared, however, West Coast crude-oil prices did not immediately decline relative to their eastern counterparts, because of the market distortions and disruptions of the transition phase.

Continuing Middle East turmoil kept world crude-oil markets tight from late-1978 to mid-1981. During this period, security of crude-oil supply usually seemed more important to refiners than potential discounts or premiums of a few dollars per barrel (which, in the case of ANS crude oil, were essentially washed out by price controls and entitlements in any case). Consequently, the North Slope producers either shipped ANS to their own refineries or engaged in exchanges which guaranteed crude-oil availability to those refineries from other sources. The biggest such transaction swapped Sohio's ANS crude oil to Chevron's District V refineries for Chevron's Saudi crude delivered to Sohio/BP east of the Rockies.

The West Coast petroleum-product market has always been very different from markets in the U.S. Midwest and East, or in Europe and the Far East. Product demand in Western North America is weighted heavily toward transportation fuels rather than heavy fuel oils (HFO). In addition, the region's air-quality problems, particularly in the Los Angeles basin, dictate that fuel oils be practically sulfur-free. The West Coast product slate and its corresponding refinery-feedstock requirements thus comport poorly with PAD District V's crude-oil endowment, which is composed largely of middle-gravity, medium-sulfur resources like ANS, and the California crude oil, which are generally even heavier and contain even greater amounts of sulfur than ANS. In order to meet a product slate that emphasizes gasoline and other light fuels, many West Coast refineries required light, low-sulfur crude oils, such as those produced in Indonesia, Alberta, and the Cook Inlet region of Alaska. Canada phased out exports of light crude oil in the 1970s, while Cook Inlet production has declined to the point that it is virtually all absorbed in Alaska. To use greater quantities of ANS and California crude oil, therefore, many West Coast refineries had to undergo costly and time-consuming upgrading.

This need to modify existing refineries was further aggravated by the changing mix of product demand. As table 5 shows, the amount of residual oil supplied to PAD District V has declined by 32 percent since 1978, while gasoline sales have declined only 7 percent. Since 1981, West Coast HFO prices have seldom risen above $28.00, even for the lowest-sulfur grades—well below average crude-oil prices. Residual-oil prices have been weak everywhere, however, because the demand for HFO has declined much more rapidly than for gasoline and diesel fuel.

Table 5
PAD District V Petroleum Products Supplied and Crude-Oil Production
(Thousands barrels per day)

	1978	1981	1982	April 1983
Products Supplied				
MoGas	1129	1034	1046	1033
Jet Fuel	301	283	283	280
Distillate	345	349	337	324
Residual Oil	488	448	330	171
Other	368	260	291	394
Total	2631	2374	2287	2202
Crude-Oil Production				
North Slope	1090	1524	1621	1599
Cook Inlet	140	85	75	66
California	951	1055	1100	1187
Other	4	3	2	2
Total	2185	2667	2799	2852

Source: *Petroleum Supply Monthly*, except April 1983 production figures are ARTA reconciliations of DOE, State of Alaska, and State of California estimates.

By 1981, as a result, most large West Coast refineries had been upgraded to produce relatively less HFO from an even heavier feedstock mix. This achievement was possible in part because the 13-percent drop in petroleum-product consumption over the same period resulted in considerable spare refinery capacity. PAD District V refinery utilization was only about 64 percent in the first quarter of 1983.[12]

As a result of lower utilization rates and refinery upgrading, West Coast crude-oil imports have declined to less than 100 Mb/b per day. This level of import is required for feedstock balancing, and there are few if any further changes that can be made to increase the utilization of PAD District V crude oils within District V. In other words, as Arco's Morrison stated, the West Coast market is a "buyers market" for crude oil, and it has been such a market at least from the time of oil price deregulation.

Economic theory suggests that West Coast ANS crude-oil prices would decline as soon as the region became a net producer. It was not until the oil-shortage mentality and petroleum price controls loosened their grip, however, that market forces had a chance to work. Once higher oil prices reduced West Coast oil demand sufficiently, Sohio faced the same kind of dilemma Saudi Arabia faces on a world scale: Sohio no longer has a large enough market share of ANS to preserve the price structure unilaterally without shipping nearly all of its own production to the Gulf Coast—and thus removing any reason to keep supporting District V netback prices. It is in this situation that Arco began pricing ANS at its Gulf Coast equivalent, less the cost of moving it there.

V. CONCLUSION

In late May, after a variety of threatened lawsuits, USA Petroleum Company filed a complaint for damages against Arco. The complaint was filed in federal district court in Los Angeles and alleges violation of federal anti-trust and a number of state laws. The pending legal actions threaten companies other than Arco. The IRS is now investigating the entire structure of California crude-oil pricing, suggesting that all West Coast crude oil might be underpriced. And, of course, Arco was not alone in undercutting its competitors' gasoline prices. In the scramble to gain or keep market share, retail gasoline prices for most companies sometimes fell below the cost of acquiring and refining crude oil.

The oil companies producing, refining and marketing in PADD V once again find themselves in a variety of contradictory litigation. From the point of view of California crude-oil producers, prices are always too low. But refiners, particularly independents, view crude-oil prices, particularly ANS prices, as too high. To these parties, events in District V over the last two years appear to be a straightforward remake of a classic John D. Rockefeller legend: predatory pricing by Arco to dominate the market. Arco, and other companies, they complain, slashed gasoline prices in a desparate attempt to win greater market shares. Once Arco's refinery capacity was fully utilized the market turned around: gasoline prices jumped almost twenty cents per gallon. The federal government has covered both ends of the arguments with two agencies, the FTC and the IRS, suggesting simultaneously that crude-oil prices are too high and too low, respectively.

But, an impartial look reveals a different story. Arco simply figured the market right. The company realized that crude-oil and petroleum-product prices had to decline, and that they would decline more steeply in District V than elsewhere, and with an exaggerated seasonal effect. Only a part of the overall price reduction can be associated directly with the drop in official OPEC prices and, even the direction of that association is ambiguous. (In our view, the market prices of petroleum products everywhere, and falling crude-oil prices in the Western Hemisphere anticipated and helped force the OPEC price adjustment.) In a falling market, Arco reasoned that the company that led the market down would gain, and those that followed would

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lose. But, it was not Arco that lowered gasoline prices; it was at bottom demand and supply.

Nonetheless, the data also suggest that West Coast crude-oil pricing still is not quite "right." In the long-run, competition should produce a single wellhead price for every kind of crude oil, including that produced on Alaska's North Slope. A two-price system arose because PAD District V made the transition from a net oil importing region to a net exporting region at the same time as a series of worldwide oil-market disruptions and major shifts in federal policy. The two-price system for ANS persists in part because of the market power of the North Slope producers and the reluctance of the federal government to pursue policies which would result in lower federal revenue. **(A.R.T. *et al.*)**

FOOTNOTES

1. Contrary to several August press stories, neither the Internal Revenue Service nor the General Accounting Office has released any report accusing Arco or the North Slope companies generally of evading Windfall Profits Taxes. While the GAO is scheduled to release a report late in 1983, our information is that neither agency is inclined to take a position on the debate over the "correct" method of determining netback prices for ANS crude oil.
2. Commissioner Michael Pertschuk, letter to Department of Justice, November 18, 1982.
3. James S. Morrison, President of Arco Petroleum Products Company, testimony before U.S. House Committee on Energy and Commerce, February 18, 1983.
4. National Petroleum News, *Fact Book*, p. 114.
5. *National Petroleum News*, June 1983, p. 22.
6. Morrison, *loc cit.*
7. Jack Blum, General Counsel, Independent Gasoline Marketers Council, testimony before the House Committee on Energy and Commerce, February 19, 1983.
8. Federal Trade Commission, Letter to Department of Justice, November 19, 1983.
9. *Oil and Gas Journal*, June 27, 1983, p. 68.
10. Federal Trade Commission, *ibid.*
11. Federal Trade Commission, *ibid.*
12. James P. Morrison, letter to Representative John Dingell, March 28, 1983.

THE SIMPLE ECONOMICS OF COMPETITIVE CRUDE-OIL PRICING IN PAD DISTRICT V (26 June, 1981)

The following text is an excerpt from a report on interfuel competition on the West Coast, which ARTA prepared for a Canadian client in June 1981. While the specific numbers are outdated (and world crude-oil prices are probably made at the U.S. Gulf rather than the Middle East today), this excerpt sets out clearly enough how West Coast crude-oil prices would be determined under fully competitive conditions.

World oil-price levels. U.S. and West Coast crude-oil prices are now (June 1981) in the process of rationalizing themselves around the $32.00 (U.S.) official price of Saudi Arabian "marker" crude. The Saudi government's current strategy is to maintain a global crude-oil surplus until competitive forces have squeezed out all price premiums and disparities that do not reflect quality or transportation-cost differentials, and thereafter to use Saudi Arabia's market power to decide whether, when, and in what direction the whole complex of world oil prices will move.

No one can forecast the actual direction of world oil prices over the next decade with any confidence, however. . . . Regardless of whether oil prices are stabilized in nominal dollars or in real dollars, surge upwards once more, or collapse to say, 1978 levels, it is almost certain that Persian Gulf crude oil will continue to be the world's marginal supply, and that petroleum prices worldwide will therefore reflect export prices at the Persian Gulf, plus transportation costs from the Gulf "basing point", and an adjustment (plus or minus) for the grade and quality of the crude oil.

U.S. and West Coast crude-oil prices. A similar process of rationalization has got under way in the United States as the February 1981 ending of oil-price controls and the entitlements system permits market forces to realign domestic crude-oil prices on the basis of quality and location. In a fully rationalized market, crude-oil prices on the West Coast of the United States would be significantly lower than those for comparable grades of oil East of the Rockies, despite slightly higher tanker charges from the primary basing point in the Persian Gulf.

The reason for lower prices in PAD District V (Alaska, Washington, Oregon, California, Arizona, and Hawaii) is that the District's refinery demand for crude oil is less than its crude-oil production (which is almost entirely from Alaska and California). District V's net exports of crude oil in 1980 were about 45

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million barrels of 123 thousand barrels per day (mb/d); because of increased production and reduced demand, net exports have now (June 1981) risen to about 400 mb/d and can be expected to continue growing until at least 1986–7, when output from Prudhoe Bay will begin to decline. (See Table A-1)

Table A-1
West Coast Crude Oil Supply and Disposition, 1977–83
(Thousands of barrels per day)

	1977	1978	1979	1980	1981	1982	April 1983
Crude-Oil Production							
N Slope	310	1090	1283	1517	1524	1621	1599
Cook In	159	137	118	99	85	75	66
Calif	957	951	965	974	1055	1102	1187
Ttl PADDV	**1424**	**2185**	**2371**	**2595**	**2667**	**2799**	**2852**
Imports	1096	602	528	429	302	190	140
Ttl Supply	2520	2787	2899	3024	2969	2990	2992
PAD District V Refinery Runs	2323	2288	2405	2347	2171	2022	1901
Tanker Shipments of Crude Oil Out of PAD District V	**40**	**245**	**373**	**617**	**568**	**786**	**900**

Source: *Petroleum Supply Monthly*, Alaska Oil and Gas Conservation Commission, and ARTA reconciliations.

The crude oil exported from the West Coast states is mostly Alaska North Slope (ANS) oil, carried in large tankers (VLCCs) from Valdez, Alaska to Panama, where it is transferred to smaller tankers that transit the Canal to Gulf Coast, Atlantic, and Caribbean refineries. After oil markets have had an opportunity to adjust to decontrol and the growing West Coast surplus, ANS crude oil will become the "marker" crude and Valdez will become the basing-point for all West Coast oil prices. Table 2 shows the way in which the "netback" value of ANS crude oil at Valdez would determine the wellhead price of a hypothetical California heavy crude oil (CHCO), on the basis of approximate current values.

The two-price system for ANS crude oil. Thus far, however, the ANS producers have been able to maintain two prices at Valdez—a netback price from the U.S. Gulf determined essentially as described in Table A-2, and a higher netback price for shipments to West Coast refineries that is established by reference to the price of imported crude oil in California, with adjustments for quality and transportation-cost differentials.

Table A-2
Determination of California Heavy Oil Price Under Competitive Conditions—As of Mid-1981
(Dollars per Barrel)

Arabian Light (AL) price FOB Ras Tanura	**32.00**
+ Tanker charge Ras Tanura to LOOP	1.25
= AL price CIF LOOP	33.25
– Quality penalty ANS is AL	– .35
= ANS value CIF LOOP	32.85
– Tanker charges Valdez to LOOP	–5.85
= **ANS price FOB Valdez**	27.00
ANS price FOB Valdez	**27.00**
+ Tanker charge Valdez to Long Beach	1.75
= ANS price CIF Long Beach	28.75
– Quality penalty CHCO is ANS	–3.05
= CHCO value CIF Long Beach	25.70
—Pipeline Kern Co to Long Beach	– .30
= **CHCO wellhead value @ Kern Co**	**25.40**

Explanation of table A-2: All parties in the table, except Petromin (the Saudi government oil company) are price-takers; they can sell all the oil they wish at the given price. Saudi Arabia may set the price because it is the marginal producer, but only if it delivers whatever the market demands at that price, no more and no less. Sohio is a price-taker at the U.S. Gulf but, until recently at least, it has been the marginal producer and therefore the price-maker on the U.S. West Coast in the same sense that Saudi Arabia has been the global price-maker. In the near future, however, Sohio will share this role with other companies, and competition will align West Coast crude-oil prices in the manner shown here.

Moving up the table, Kern County is a net exporter of heavy crude oil; producers they can sell as much as they wish (within limits) by "backing out" ANS crude from Los Angeles basin refineries; to do so, they must pay (30 cents per barrel) for gathering and overland transportation, and accept a discount ($3.05) relative to the CIF price of ANS crude ($28.75) that corresponds to the higher cost of refining the heavy crude and the lower value of the products made from it. Los Angeles basin refiners, in turn, can obtain as much ANS crude oil as they want, by paying tanker charges from Valdez ($1.75) plus an FOB price equal to what the producer would get for it CIF the U.S. Gulf ($32.85) less the cost of shipping it there ($5.85). The FOB value of ANS crude oil at the U.S. Gulf is the CIF price at which refiners can get Arabian Light ($33.25), less a penalty for the lower quality of ANS crude (35 cents); and the CIF price of Arabian Light is the FOB Persian Gulf price ($32.00) plus tanker transport-costs ($1.25).

Lower prices for ANS crude would have allowed the ANS producers to sell more oil in District V, by accelerating substitution of ANS oil for imports and by retarding the development of high-cost

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heavy-oil production in California. But such price reductions by one ANS producer would have met with comparable reductions by other ANS and California oil producers. The increase in the number of barrels of District V crude oil refined on the West Coast would have been relatively small, so that the total revenues of all West Coast producers would have declined. It has therefore been in the interest of the ANS and California producers that West Coast crude-oil prices remain above the levels that would have prevailed in a competitive, rationalized market. A special factor that dampened producer competition for West Coast petroleum markets was the price control system which, from about July 1979 until February 1981, made producers of price-controlled ANS oil indifferent to its transportation cost and, beginning in 1974, had made a large proportion of California's heavy oil uneconomic to produce.

Finally, the Windfall Profits Tax (WPT), which was imposed on decontrolled crude oil in January 1980, drastically reduces the incentive of individual ANS producers to optimize their transportation and marketing arrangements in order to maximize wellhead revenues. The WPT leaves the ANS producers only 8 cents out of each dollar's increase in the wellhead price after payment of royalties, State severance taxes, and State and Federal income taxes. An effective marginal tax rate of 92 percent on oil-production revenues clearly invites integrated oil companies to find means of shifting some of their profits from crude-oil production to their refining or transportation operations, which are taxed at much lower rates.

Where a producer's marginal tax rate is 92 percent, the WPT creates an incentive, for example, for the producers to ship their crude oil to affiliated refineries at an artificially low "transfer" price, or to arrange exchanges with other integrated companies that have a similar incentive to understate the value of their crude oil, even when doing so requires otherwise unnecessary transportation expense that reduce netback prices at the wellhead.

Despite the interest of all West Coast producers in preserving the two-price system for ANS crude oil, it has been able to survive until now only because one company, Sohio, was the marginal supplier of domestic oil to West Coast refineries, and the main exporter of West Coast oil to the Gulf and Atlantic coasts. Since 1977, that position has given Sohio the power to determine District V oil prices within a wide range, by deciding how it will allocate its ANS crude oil between West Coast refineries and refineries East of the Rockies. Understandably, the company has not chosen to "spoil" its own District V market (and everyone else's) by competing vigorously for a slightly larger share of that market.

End of the two-price system. Price controls and the entitlements system are gone, and Sohio is losing (if it has not already lost) its special ability to support West Coast oil prices; thus, the two-price arrangement for ANS crude oil at Valdez is unlikely to survive the intensified competition for market shares that will occur in the 1980's. Because of the general decline in petroleum-products consumption and the growth of ANS and California heavy-oil production, ARCO and Exxon (as well as Sohio) are already having to ship substantial amounts of ANS crude oil East of the Rockies. ARCO will begin producing from the Kuparuk River formation at Prudhoe Bay in 1982; year-end production will be about 80 mb/d, and may rise to as much as 200 mb/d by 1985. The anti-trust laws forbid the producers from coordinating their decisions on allocation of ANS crude oil between District V and other markets, but without such coordination, Sohio, Exxon, and Arco are doomed to compete with one another trying to sell crude oil to Chevron, Union, and other West Coast refiners. The State of Alaska may also aggravate the downward pressure on District V prices by its policy of selling royalty oil independently of the ANS producers . . .

Finally, California heavy-oil production continues to grow. The biggest producers are Getty and Shell. Getty has only about 5 mb/d of ANS production and Shell has none; thus they will have no reason not to price their California product at whatever levels clear the market—at the expense of ANS sales to California refiners. All in all, the outlook is for vigorous price competition throughout District V in the 1980's and a rapid rationalization of prices in the District around the price of ANS crude oil at Valdez.

The ANS producers could still forestall the erosion of West Coast oil prices relative to the price of Middle Eastern imports, if they were permitted to ship ANS crude oil to the Far East; the highest attainable netback value at Valdez would probably result from foreign-tanker shipments to Japan, where its value is equal to or higher than that of Arabian Light. The relative value of West Coast petroleum would also increase if a large-volume crude-oil pipeline system connected District V with the Midwestern States (but only if that pipeline were utilized at or near its design capacity). However, the Export Administration Act forbids overseas exports of ANS crude oil, and the near-term outlook is not favorable either for liberalization of exports or for construction of a new transcontinental pipeline system along the lines of those proposed by Trans-Mountain, Northern Tier, or Foothills.

These conditions mean that competition will press the entire structure of PAD District V crude-oil prices toward a level three to four dollars below those of the Gulf and Atlantic coasts. The April 1981

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appearance of a West Coast spot price for ANS crude oil ($31.00) three dollars below the average Gulf Coast contract price ($33.97) and more than two dollars below the Gulf Coast spot market price ($33.30) may be evidence that sufficient price competition already exists to bring about this result.

ROLL OUT THE BARREL

By our OPEC Observer

From Riyadh to Glasgow, OPEC ministers and industry executives are celebrating the success of Saudi oil policy. Once again Saudi Oil Minister Yamani seems to have achieved a miracle. The diverse factions of OPEC have for the time being been mollified: the members' March agreement on production quotas and price differentials appears to be holding. Crude-oil prices, after four years of turmoil, have finally "realigned" themselves so that price differentials are almost entirely a function of crude-oil characteristics and transportation costs, rather than divergent pricing policies by different OPEC countries.

Tranquility has had its price, however. Average official crude-oil prices dropped from $35.53 per barrel in early 1981 to a low of $28.55 in April 1983. This was a plunge of over 25 percent in constant-dollar terms—by far the biggest and steepest in more than half a century. OPEC is happy to overlook this setback because the cartel seems to have served as a safety-net when it was really needed; without the ability of OPEC to agree on quotas, the price decline could easily have become a rout.

Table O-1
1983 Key Production Rates
(Millions of Barrels Per Day)

	January	February	March	April
Saudi Arabia	4.6	3.6	3.5	3.9
Iran	2.7	2.4	2.2	2.0
Iraq	.8	.8	.8	.8
Kuwait	.6	.8	.9	.7
Venezuela	2.1	1.8	2.1	1.7
Nigeria	.9	.7	.9	1.2
Libya	1.1	.9	.9	1.0
Indonesia	1.2	.9	1.1	1.2
Other OPEC	2.6	2.4	2.2	2.8
Total OPEC	**16.6**	**14.3**	**14.7**	**15.3**
United States	8.7	8.7	8.7	8.7
North Sea	2.7	3.0	2.9	2.8
Mexico	3.0	2.3	2.4	2.7
U.S.S.R.	12.4	12.4	12.4	12.4
Other	11.6	11.7	11.6	11.6
Non-OPEC	**38.4**	**38.1**	**38.0**	**38.2**
Total world	**55.0**	**52.4**	**52.7**	**53.3**

Petroleum Intelligence Weekly, various issues.

The OPEC nations were able to manage a price reduction and end the cut-throat competition only by dropping production rates to as low as 14.3 million barrels per day in February 1983, less than half their production in 1978, and almost twenty-five percent below first-quarter 1982. Since February 1983, OPEC production has averaged around 15 million barrels per day, far lower than most analysts thought OPEC would ever need to achieve, let alone be able to sustain for longer than a few weeks.

In the first quarter of this year, Saudi oil production averaged less than 4 million barrels per day, a fifty percent decline from the year before, and only about one-third of installed production capacity. Other OPEC countries are also contributing to price-maintenance by withholding supply. Nigeria's first quarter oil production was forty percent lower than that of a year earlier and Indonesia's production was down nearly thirty percent.

Despite recent reports indicating that both Nigeria and Iran are cheating on their production quotas, the increase in supply has not been enough to upset the pricing structure. Spot crude oil prices, as typified by the Rotterdam spot price for Saudi light crude oil, have stabilized at slightly less than $29.00 per barrel. Reduced OPEC crude-oil production rates thus ended the price slide and successfully stabilized the market. Nothing else explains the cartel's success, since nothing else could have eliminated the driving force behind this winter's sagging prices and excess supply.

Other oil-market indicators confirm OPEC's continued short-term success. Crude-oil and petroleum-product inventories have been depleted nearly as far as practical. In the United States, gasoline demand has picked up as motorists take to the highways for summer vacations. As a result, gasoline prices have substantially strengthened, even if one takes account of the increase in federal taxes. In some instances, retail prices are up by 20 or more cents per gallon. Product spot prices are stable and on occasion provide a small level of profitability for refiners stuck with excess capacity.

Residual-oil prices have also held up surprisingly well. Despite the fact that official OPEC crude-oil prices have declined by $5 per barrel, residual oil prices in 1983 have been as high as in 1982. This seems to confirm the view that heavy fuel-oil (HFO) price movements are largely independent of (or indeed lead) Western Hemisphere and world crude-oil price movements within a wide range, and suggests that oil is improving its competitive position in boiler-fuel markets, indicating a slowdown or turnaround in the frantic pace of fuel-substitution since 1979.

For OPEC's present success to hold, oil demand must pick up with economic recovery—more

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rapidly indeed than overall economic activity, if recovery if recovery is to offset the many delayed and gradual reactions to the price upheavals of the 1970's. It is important to remember that the fruits of an economic upturn will include the more rapid replacement of existing buildings, transportation equipment and industrial machinery with more energy-efficient (and particularly less oil-demanding) models designed since the mid-1970's. The potential for demand growth in the gasoline and diesel-fuel market will be limited by conservation regulations and continuing consumer investments in energy saving equipment. Any oil-demand growth will thus likely appear in the boiler-fuel market (which was responsible for the greatest shrinkage in oil demand over the last five years). Thus, residual oil must remain competitive with natural gas and coal—a questionable test even at today's lower (real-dollar) oil prices. Thus, there is reason to doubt the long-term viability of the present price structure, for the same reason we repeatedly questioned the pre-1983 levels.

Since last year, the New York Mercantile Exchange (NYMEX) has opened a new futures market in crude oil, in addition to its booming markets in gasoline and heating oil. The combination of contract, spot and futures prices in crude and product markets provides an interesting basis from which to compare and track oil prices, in order to measure OPEC's progress or retreat.

Table O-2 above shows the movement of the spot price for Saudi light in Rotterdam, the spot price for Alaska North Slope (ANS) in the Gulf Coast, and the NYMEX crude-oil price six months forward of the date on the table. These figures makes two things quite clear. Crude-oil futures prices are moving with U.S., not Rotterdam prices. Moreover, they are moving with the spot, rather than the contract market. During this period there was no significant change in posted wellhead prices for domestic crude oil.

Table O-2
1983 Crude-Oil Prices
(Dollars per Barrel)

Month and Date	Saudi Light (Rotterdam-Spot)	Six-Month Futures (U.S.)	ANS (U.S. Gulf Spot)	West Texas Sour
June				
2nd week	28.78	30.19	29.47	29.00
3rd week	28.85	30.79	29.77	29.00
4th week	28.91	30.85	29.90	29.00
5th week	28.90	30.93	29.69	29.00
July				
1st week	28.91	30.88	29.81	29.00
2nd week	29.04	31.39	30.14	29.00
3rd week	29.03	31.47	30.02	29.00
4th week	28.97	31.30	29.96	29.00
August				
1st week	29.02	31.90	30.25	29.00

Wall Street Journal, various issues.

Significantly for OPEC and speculators in the oil-trading game, the rise in current U.S. crude-oil prices has been accompanied by a more-than-proportional rise in futures prices. Thus, the price for February deliveries is about $32, substantially greater than the present official price, including the cost of tanking the oil to New York. Since many OPEC officials fear the return of a glutted market this winter, it would not be surprising to see some OPEC national oil companies becoming bona-fide hedgers, and in effect selling their oil in advance at the current futures price.

Gasoline is the most profitable of all products for U.S. refiners, so when its demand is up they are willing to pay more for crude oil. However, the demand will fall off rapidly after September. In short, spot crude-oil prices in the U.S. are likely to decline in a normal seasonal pattern, moving once again in line with Rotterdam prices. When this occurs, crude-oil futures prices will also decline, particularly if speculators once more begin to worry about OPEC viability in the first quarter of 1984. (SVV)

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FORTHCOMING ANALYSES: NATURAL GAS INSIGHTS

Edited by Arlon R. Tussing and Connie C. Barlow

No. 2 September 1983. **Gas-Pipeline Prorationing vs. Prorationing by State Regulators.** The 1983 gas glut has reactivated long-forgotten "economic conservation" and common-purchaser rules in the gas-exporting states. A three-way battle is shaping up among pipelines, producer-state regulators, and FERC over who allocates demand among producers and gas vintages. The September issue of **Natural-Gas Insights** provides an overview of this issue, and examines its national implications.

No. 3 October 1983. **The Emergence of a Natural-Gas Spot Market.** The natural-gas industry can hold its industrial markets only if prices and sales volumes are free to move continuously with changes in business conditions and the prices of competing fuels. Spot markets of sorts already exist in Texas and Louisiana intrastate markets, and several interstate pipelines are innovating with quasi-spot market schemes on their own systems. ARTA believes that national and regional spot markets are inevitable. The October issue of **Natural-Gas Insights** considers the pace and form in which these markets will develop.

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PUBLICATION SCHEDULE: PACIFIC OIL INSIGHTS

Edited by Arlon R. Tussing and Samuel A. Van Vactor

No. 2 September 1983. **Interfuel Competition and the West Coast Residual Oil Market.** The September issue of **Pacific Oil Insights** analyzes the factors that determine the prices of heavy fuel oil on the West Coast, and govern its competition for industrial markets in California, the Pacific Northwest, and British Columbia.

No. 3 October 1983. **Will Canada Again be a Major Oil Exporter?** The October issue of **Pacific Oil Insights** will focus on the reappearance of an exportable surplus of light crude oil in Alberta, and its likely destination markets and export terms. It will also take up the implications of the promise by Trudeau's likely successor Brian Mulroney, to "market Canada's oil and gas aggressively in the United States."

No. 4 November 1983. **The 1983 Oil-Price Outlook.** The October issue of **Pacific Oil Insights** will contain ARTA's second annual oil-price outlook report. We shall forecast world oil production and consumption by region and country, oil-export earnings and payments balances for OPEC countries and other major oil-exporters, and the course of prices over the year.

No. 5 December–January 1983-4. **Alaska/California - Production Forecasts.** The Winter issue of **Pacific Oil Insights** will contain ARTA's first annual forecast of onshore and offshore Alaska and California crude-oil production by area through the year 2000.

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- Monthly Feature: The OPEC Observer

ABOUT THE EDITORS

The editors of ARTA's **Natural-Gas Insights** are North America's most successful forecasters of gas-industry developments. In 1981, Tussing and Barlow were alone in pointing out that "the price fly-up" which others were predicting for 1985 "is **now**," that gas markets would clear within a few months, and that the most fashionable slogan in the gas industry would soon be "I can't take and I won't pay, so sue me!"

The editors of ARTA's **Pacific Oil Insights** have been among the leading analysts of Pacific Rim oil markets for many years. They accurately predicted the timing and shape of the turndown in world oil prices which began in 1981, and the emergence of crude-oil price "discount" on the U.S. West Coast, relative to world or Gulf Coast prices.

Arlon R. Tussing is president of ARTA Inc., and professor of economics at the University of Alaska. He was chief economist of the U.S. Senate Committee on Energy and Natural Resources, and has served on the Economic Advisory Board of the U.S. Department of Commerce. Tussing is the author of almost two hundred books, reports, and articles on energy, natural resources, environmental policy, and finance. **Connie C. Barlow** is based in Juneau, Alaska and is vice president of ARTA Inc. She has served in senior staff positions in the Alaska Department of Natural Resources and the Alaska State Legislature. Barlow is author or co-author of numerous articles and reports on resource and energy issues, particularly natural gas. **Samuel A. Van Vactor** is based in Portland and Los Angeles, and was most recently director of the Northwest Energy Policy Workshop at Portland State University. He has been director of planning in the Oregon Department of Energy and senior economist at the International Energy Agency.

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APPENDIX E.—ADDITIONAL MATERIAL SUPPLIED BY EXXON

THE DETERMINATION OF REMOVAL PRICE

for

OIL PRODUCED FROM THE SADLEROCHIT RESERVOIR

for purposes of

WINDFALL PROFIT TAX

prepared by

EXXON COMPANY, USA

September 8, 1983

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THE DETERMINATION OF REMOVAL PRICES FOR OIL PRODUCED FROM THE SADLEROCHIT RESERVOIR FOR PURPOSES OF WINDFALL PROFIT TAX

In the determination of removal prices for crude oil produced from the Sadlerochit reservoir, there are only two sections of the Crude Oil Windfall Profit Tax Act of 1980[1] that may have any application. The first is Section 4988(c)[2] which is titled "Removal Price" and the second is Section 4996(d)(1)[3] which is included in a section titled "Other Definitions And Special Rules" with the subsection titled "Alaskan Oil From Sadlerochit Reservoir—Removal price determined on monthly basis." Though titles may have no significance in interpreting a statute,[4] there is at least an indication by Congress in the choice of these titles that there is something unique about the determination of removal prices of Alaskan oil from the Sadlerochit reservoir.

Section 4988(c) is a section of general application in the calculation of windfall profit tax. The section provides rules for determination of removal price. If crude oil is sold on the premises then the sales price is the removal price. If crude oil is sold to a related party before removal, removed before sale, or if refining commences before removal, then the removal price shall be the constructive sales price determined under Section 613.

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[1]Pub. L. No. 96-223, 94 Stat. 229 (1980).

[2]I.R.C. § 4988(c). Section references hereafter are to the Internal Revenue Code of 1954, 26 U.S.C., as amended.

[3]This section was originally enacted as Section 4996(d)(1)(B) and was subsequently amended by Pub. L. 97-248. References hereafter are to the section as amended unless otherwise indicated.

[4]I.R.C. § 7806(b).

Section 4996(d)(1) provides a special rule applicable solely to crude oil produced from the Sadlerochit reservoir and is not applicable to any other production in the United States. This rule provides that a Sadlerochit producer's removal prices are to be averaged within a calendar month. The averaging is to be done by each producer separately.

A. The purpose of the statute and the facts related to Sadlerochit production should be considered in interpreting the statute.

The windfall profit tax is one of the most complex taxes ever devised. The meaning of almost any provision of the tax is difficult to comprehend and is easily misunderstood. These difficulties may be minimized by first reviewing the purpose of the tax[5] and the circumstances existing at the time of enactment.[6] This review should aid in understanding the meaning of the provisions described above and the reason for their adoption.

The purpose of the windfall profit tax was addressed by both the Committee on Ways and Means, U.S. House of Representatives, and the Committee on Finance, U.S. Senate, in their reports to Congress. The Report of the Committee on Ways and Means addressed the purpose in two different places:

> The committee believes that there should be a tax on the windfall arising from decontrol of crude oil prices and from excessive increases in world oil prices.[7]

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[5]Haggar Co. v. Helvering, 308 U.S. 389 (1940).

[6]La Belle Iron Works v. U.S., 256 U.S. 377 (1921).

[7]H.R. REP. No. 96-304, 96th Cong., 1st Sess. 4 (1979) (Hereafter referred to as the "House Report"); 1980-3 C.B. 88.

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> Thus, the committee believes that the additional revenues received by oil producers and royalty owners, both as a result of decontrol of oil prices and as a result of increases in world oil prices substantially above those prevailing in 1978, are an appropriate object of taxation.[8]

The Report of the Committee on Finance addressed the purpose of the windfall profit tax as follows:

> The Finance Committee substitute is intended to tax a fair share of the additional revenues received by oil producers and royalty owners as a result of oil price decontrol in a way that will not adversely affect incentives to produce domestic oil.
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> The committee believes that the large price increases on previously discovered oil resulting from phased decontrol are an appropriate object of taxation.[9]

The above quotations establish that the legislative purpose was to impose a tax on the excess of the price received for crude oil over the price that would have been received had crude oil price controls been continued. The object of the tax then was the decontrol benefit received by persons owning economic interests.

With this purpose in mind, Congress also needed to determine the most expeditious means of measuring the decontrol benefit of a given producer and thus needed to understand the manner in which crude oil is valued and marketed within the industry. Crude oil production is generally sold based on prices posted

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[8]House Report, p. 7; 1980-3 C.B. 91.

[9]S. REP. No. 96-394, 96th Cong., 1st Sess. 6 (1979) (Hereafter referred to as the "Senate Report"); 1980-3 C.B. 142.

by crude oil purchasers for a given gravity of crude oil in a given field.[10] Fields do exist in the United States where there is no price posted by purchasers. This generally occurs when one or more integrated producers own all the production and are taking their shares of production in kind for delivery to their own refineries.

Congress was aware that there were no crude oil purchasers posting prices for Sadlerochit oil in or near the Prudhoe Bay field. The total availability of Alaskan and other West Coast crude exceeded West Coast Refinery requirements and significant volumes of North Slope crude moved to refineries east of the Rocky Mountains.

It is significant that the valuation, or wellhead price determination, of North Slope crude oil is addressed by the staff of the Joint Committee on Taxation in a pamphlet prepared for the Committee on Ways and Means.[11] Included are the following statements:

> Essentially, the wellhead price for Alaskan oil will equal the price at which the oil can be sold to a refiner in the lower 48 States (or abroad, if the law is changed to permit export of Alaskan oil), minus the transportation costs from the wellhead to the refinery . . .
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[10]Congress used the posted price system as a basis for determining interim base prices for tiers two and three of the tax. Section 4989(d)(2). See also H.R. REP. No. 96-817, 96th Cong., 2nd Sess. 96 (1980) (Hereafter referred to as the "Conference Report"), 1980-3 C.B. 256.

[11]Staff of the Joint Committee on Taxation, The Design of a Windfall Profit Tax (Comm. Print 1979).

> Under the Administration's proposal, and H.R. 3919, oil produced from a well located north of the Arctic Circle would be exempted entirely from the windfall profit tax, including the third, or OPEC, tier of that tax. This exemption is intended, in part, to eliminate the possibility of creating a disincentive for the production of Alaskan oil, and in apparent recognition of the large disparity between the wellhead price of oil produced north of the Arctic Circle and its actual refinery selling price.
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> * * * * *
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> There are numerous ways to impose a third tier tax on Alaska oil which would provide some recognition of the special characteristics of it.[12]

The purpose of the pamphlet from which the above quotations are taken was to advise the Committee on Ways and Means as to the issues that had to be resolved in designing a windfall profit tax.[13] Thus, from the earliest days of the inception of the windfall profit tax, it is apparent that Alaskan oil was considered a special situation deserving of special treatment.[14]

No property in the entire United States received any more intensive and thorough examination during the enactment of the Windfall Profit Tax than the Sadlerochit reservoir. The Sadlerochit reservoir is the only property mentioned in the statute. Congress even knew the geologic names of the multiple reservoirs in the Prudhoe Bay field.[15] Separate revenue estimates were made

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[12]Id., p. 20-23, cited with approval in U.S. v. Ptasynski, et. al., 103 S. Ct. 2239 (1983).

[13]Id., p. 1.

[14]See also, the President's message to the Congress of the United States transmitting the Administration's proposal for a Windfall Profit Tax, April 26, 1979.

[15]House Report, p. 30, 1980-3 C.B. 112; Senate Report, p. 43, 1980-3 C.B. 161; Conference Report, p. 102, 1980-3 C.B. 262.

for this one property which was subject to its own separate special treatment in the House version of the legislation.[16] Each of the three Committee Reports devotes special attention to the tax treatment of the Sadlerochit reservoir.[17] It was even the subject of a press release by the Senate Finance Committee.[18] There could be no clearer record that Congress considered the Sadlerochit reservoir to be a unique and special problem deserving of its own special solution.

B. Considering the purpose of the tax and the facts relevant to the Sadlerochit reservoir, section 4988(c) has no application to production from the Sadlerochit reservoir.

Against the background of the purpose of the windfall profit tax and the facts available to Congress to choose a manner of measuring the decontrol benefit, it is apparent that Section 4988(c) was enacted for the purpose of fixing the upper limit of the decontrol benefit.[19] This section codifies the rules formerly used to determine gross income from the property for percentage depletion purposes.[20] These rules represent an appropriate upper limit to the decontrol benefit received because they are intended to determine the price that would have been received had the crude oil been sold at the wellhead.[21]

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[16]Staff of the Joint Committee on Taxation, Conference Comparison on H.R. 3919 (Crude Oil Windfall Profit Tax Act of 1979) (Comm. Print, December 18, 1979).

[17]House Report, p. 30, 1980-3 C.B. 112; Senate Report, p. 36-37, 1980-3 C.B. 154-155; Conference Report, p. 103, 1980-3 C.B. 263.

[18]U.S. Senate, Committee on Finance, Press Release #145, October 9, 1979.

[19]The lower limit is the sum of the adjusted base price and the severance tax adjustment. See Section 4988(a).

[20]See Treas. Reg. § 1.613-3(a).

[21]Panhandle Eastern Pipe Line Co. v. U.S., 408 F.2d 690 (Ct. Cl., 1969).

Considering that the purpose of the legislation was to tax the decontrol benefit received by each producer and in light of the special circumstances known to Congress which surround the Sadlerochit reservoir, it is submitted that Section 4988(c) was never intended to apply to the Sadlerochit reservoir. Congress recognized that the Sadlerochit reservoir did not possess the same characteristics as other fields in the United States[22] and that a single price in the area of the Prudhoe Bay Unit was not available. Even if one could be constructed, it would not properly measure the decontrol benefit received by each of the North Slope producers.[23] There was no posted price for this crude oil at the time of enactment and none exists today, almost four years later. Furthermore, demand in the nearest area of refining capacity was not sufficient to absorb the entire volume of production from the Sadlerochit reservoir. Thus the decontrol benefit received by any producer of Sadlerochit crude oil could not be measured in the same manner as other crude oil produced in the United States because it depended on the value at point of destination of each producer's crude oil. The rules of section 4988(c) were proper for determining the removal price for all other properties in the United States but not for Sadlerochit production. Thus, section 4988(c) has no application to determining removal prices for Sadlerochit production.

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[22]See quotations at n. 12, supra. See also n. 14.

[23]The House Report even describes a classical method used to determine the wellhead price of any oil in the context of Alaskan oil. House Report, p. 30; 1980-3 C.B. 112. Though the description is under the heading "Treatment under price controls," the method is not unique to price controls but results from competitive processes and depends on the refinery location to which the oil is delivered.

C. Congress provided a special rule for determining the removal price of Sadlerochit oil recognizing the purpose of the tax and the special circumstances relating to the valuation of Sadlerochit oil.

The object of the tax and the circumstances surrounding the valuation of Sadlerochit oil made necessary a special rule for this oil which was provided by Section 4996(d)(1). There seems little doubt that Section 4996(d)(1) is a special rule for one property only since the Sadlerochit reservoir received such significant individual attention at all steps in the legislative process. Since it is a special rule it should be examined separately to determine its meaning. The statutory provision is as follows:

> The removal price of Sadlerochit oil removed during any calendar month shall be the average of the producer's removal prices for such month.[24]

The first reference to the term "removal price" in the quoted statutory provision must be for purposes of Section 4988(a) where the windfall profit which is the object of the tax is defined by upper and lower limits. The real question is what is the special rule applicable to the determination of removal prices for Sadlerochit oil. Whatever the rule is, it is contained in Section 4996(d)(1) and this provision must be examined to determine Congressional intent. The provision requires averaging within a calendar month, a requirement not applicable to any other production in the United States. Averaging by Sadlerochit producers of the two different types of removal prices provided by

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[24]I.R.C. § 4996(d)(1). Prior to the amendment by Pub. L. 97-248, this section was introduced by the phrase "In the case of Sadlerochit oil" indicating a special rule was intended.

Section 4988(c), sales on the premises and constructive sales prices, would fail to explain why such averaging is not required for all other production in the United States. The windfall profit tax is an excise tax[25] levied on each barrel[26] of crude oil removed from the premises. Since the averaging requirement is unique to the Sadlerochit reservoir, it must mean that there is something unique about the determination of removal prices for barrels of crude oil produced from the Sadlerochit reservoir or else the averaging requirement would also apply to all other production. As described above[27] Congress was aware of the special circumstances applicable to the wellhead valuation of Sadlerochit oil and it is reasonable to conclude that Congress was attempting to give effect to these special circumstances in the provisions of Section 4996(d)(1). Why Congress chose to use the words "removal prices" in this special section is not known, but incorporation of the definition in Section 4988(c) would still fail to explain the averaging requirement for Sadlerochit producers. Furthermore, the statutory words "removal prices" in section 4996(d)(1) are modified by the singular possessive word "producer's" indicating something different than a "field" price that might be determined under Section 4988(c). If ambiguity exists in the statutory use of the words "removal prices" in Section 4996(d)(1), it is compounded, not resolved, by the incorporation of the definition in Section 4988(c). Since the same words used in a different context in the same statute can have different meaning,[28] the meaning of the words in Section 4996(d)(1)

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[25]I.R.C. § 4986(a). See also House Report, p. 2, 1980-3 C.B. 86; Senate Report, p. 2, 1980-3 C.B. 138; and Conference Report, p. 92, 1980-3 C.B. 252.

[26]See, for example, I.R.C. § 4987(a), 4987(c), 4988(a), 4988(b)(1), and 4989(a).

[27]See quotations at n. 12 and material cited in n. 16, 17, 18, and 23.

[28]Helvering v. Stockholms Enskilda Bank, 293 U.S. 84 (1934).

should be sought in the legislative history,[29] not in the general rule of Section 4988(c).

D. The legislative history of section 4996(d)(1) explains the special rule for determination of removal prices for Sadlerochit oil.

All versions of the bill as finally enacted included the special rule requiring monthly averaging by each producer for Sadlerochit removal price determination.[30] The Senate Finance Committee version and the Senate version included language addressing "deemed removals" but this was not adopted by the Conference Committee. "Deemed removals" are a question of the timing of the tax and the special rule was addressing the amount of the tax for Sadlerochit producers.

The Conference Report states that the conference agreement follows the Senate amendment.[31] The Conference Report restates the meaning of the Senate amendment in the following language:

> . . . [T]he tax on Sadlerochit oil is calculated on the basis of monthly average removal prices for each producer, as in the House bill.[32]

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[29]Consider Revenue Ruling 81-309, 1981-2 C.B. 225, where the meaning of the words "project beginning date" in section 4993(c)(2)(B) were sought in the legislative history, not in the statutory definition contained in section 4993(d)(2).

[30]H.R. REP. No. 304, 96th Cong., 1st Sess. § 2(a), p. 32 (June 22, 1979); H.R. 3919, 96th Cong., 1st Sess. § 2(a) (June 28, 1979); S. REP. No. 394, 96th Cong., 1st Sess. § 101(a), p. 48-49 (November 1, 1979); H.R. 3919, 96th Cong., 1st Sess. 50 (December 17, 1979).

[31]Conference Report, p. 103; 1980-3 C.B. 263.

[32]Id.

This confirms what is readily apparent from the statute. Each producer individually is required to average its multiple removal prices. Such language is inconsistent with the use of a single price applicable to all producers, however determined. Thus, Congress did not intend for there to be one price at any point in time for all producers of Sadlerochit oil. The quoted language of the Conference Report further confirms that both the House and the Senate provided the same rule and both are consistent on this point. Therefore, either or both of the Committee Reports are relevant regarding the meaning of Section 4996(d)(1).

There is a paragraph explaining the meaning of Section 4996(d)(1) in both the House Report and the Senate Report. Because of their significance, each is quoted hereafter. The House Report states as follows:

> The windfall profit subject to tax on the sale of Sadlerochit oil by any producer is the amount by which the average removal price for a barrel of that producer's oil during the month exceeds the adjusted base price of oil from the property. The average wellhead price for each producer is used in lieu of the actual sale price of each particular barrel of oil to make sure that wellhead price differentials attributable only to the final destination of a particular barrel of Alaskan oil do not affect windfall profit tax liabilities. (Unlike other oil, North Slope oil will have a different wellhead price depending on its final destination of the oil because each integrated producer determines the wellhead price for each barrel by subtracting transportation costs from the price of the oil at the refinery gate.)[33]

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[33]House Report, p. 31; 1980-3 C.B. 113.

The relevant paragraph from the Senate Report is as follows:

> In the case of Sadlerochit oil, the tier two tax would be calculated on the basis of average monthly removal prices for each producer. The average wellhead price for each producer is used in lieu of the actual sale price of each particular barrel of oil to make sure that wellhead price differentials attributable only to the final destination of a particular barrel of Alaskan oil do not affect windfall profit tax liabilities. (Unlike other oil, North Slope oil will have a range of wellhead prices in a particular month depending on the final destination of the oil because each integrated producer determines the wellhead price for each barrel by subtracting transportation costs from the price of the oil at the refinery gate).[34]

The first sentence of each of these quotations is slightly different but each repeats the averaging requirement of the statute. Both sentences emphasize that each Sadlerochit producer will have his own removal prices rather than a single price applicable to all producers. The House Report does this by the use of the words "that producer's oil" in the first sentence while the first sentence of the Senate Report provides the same emphasis by use of the words "for each producer."

The second sentence is precisely the same in both reports, again showing there is no conflict between the House and Senate and again emphasizing "each producer". The third sentence is slightly different in the two reports but only in choice of words, not in meaning, with the Senate version being the clearer of the two. The second sentence can easily be misunderstood unless the third sentence is examined first.

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[34]Senate Report, p. 36; 1980-3 C.B. 154.

The third sentence of both the House and Senate Reports explaining the meaning of Section 4996(d)(1) is introduced by the phrase "Unlike other oil." Of all the words from the English language that might have been chosen, none could demonstrate a more clear intent by Congress, both the House and the Senate, that oil produced from the Sadlerochit reservoir was not to be treated as all other oil subject to the windfall profit tax. These words indicate that Congress knew they were providing a special rule in Section 4996(d)(1) applicable only to oil produced from the Sadlerochit reservoir and that the general rule of Section 4988(c) was to have no application to Sadlerochit oil.

The remainder of the third sentence provides the reason for the wording of Section 4996(d)(1). It first provides that North Slope oil will have a range of wellhead prices in a particular month. The range of wellhead prices depends upon the final destination of the oil thus providing more meaning to the reason why there is a range of wellhead prices. The reason the destination of the oil is controlling is because the wellhead price of a Sadlerochit producer is determined by subtracting transportation costs from the price of the oil at its destination, generally the refinery gate. If the total production of a single Sadlerochit producer in a given month does not go to one destination then oil delivered to different destinations will have a different range of wellhead prices. If there are multiple deliveries to a single destination in a single month and the value at destination changes between deliveries then this will also result in a different range of wellhead prices. The third sentence therefore provides clear direction as to the reason and the method of determining the removal price of each barrel removed by a Sadlerochit producer. It is not the same as the rule provided in section 4988(c).

After considering, analyzing and understanding the third sentence of the relevant quotations, the second sentence is much easier to understand. This second sentence explains the reason that averaging of the range of wellhead prices as determined by the method provided in the third sentence is required. This is to prevent the range of wellhead price differentials attributable only to the final destination of a particular barrel of oil from affecting total windfall profit tax liability of a Sadlerochit producer. In other words if two barrels of oil were produced and the first were transported a sufficient distance so that the wellhead value of that barrel after reduction for transportation costs were less than the adjusted base price then, without averaging, only the second barrel, assuming a higher wellhead value, would be subject to windfall profit tax. This would produce an erroneous overstatement of the decontrol benefit, which is the object of the tax, received by that producer. The tax would be erroneously reduced, without averaging, if both barrels were above the adjusted base price but the barrel with the higher wellhead value was subject to net income limitation.

E. The explanation of section 4996(d)(1) in the legislative history is clear that section 4988(c) has no application to Sadlerochit oil and gives meaning to all the words of section 4996(d)(1).

After understanding the method of removal price determination for Sadlerochit oil provided by the legislative history, it is clear that the method is not the same as that provided by Section 4988(c) and Section 4988(c) was never intended to apply to Sadlerochit oil.

Consistent with the words of the Committee Reports regarding the determination of removal price for Sadlerochit oil, all the words of Section 4996(d)(1) have meaning without any strained reading. The words "producer's removal

prices" indicate that each producer is to determine his own removal prices based on his own disposition of Sadlerochit oil. Each Sadlerochit producer can have multiple removal prices because they are determined based on the value of the oil at destination less the transportation costs to reach that destination. Unlike other oil in the United States, averaging of the removal prices so determined for Sadlerochit oil is required to avoid inequities to the taxpayer and the government in the measurement of the decontrol benefit.

F. Revenue Ruling 83-124 is in error if it requires the determination of a single representative market or field price on the North Slope for use as the removal price by all Sadlerochit producers.

The holding in Revenue Ruling 83-124[35] provides that the method for determining removal price for North Slope crude oil removed from the premises before sale is the method based on the principles for determining gross income from the property under Section 613 of the Internal Revenue Code. There is no other way to read the ruling than to conclude that the holding means that producers from the Sadlerochit reservoir who do not sell on the premises must determine the representative market or field price for use as the removal price for windfall profit tax purposes.

The case law interpreting the term "representative market or field price" for percentage depletion purposes includes strong language[36] that such a price, once determined, is applicable to all producers in the field. Thus, it follows from an

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[35]1983-34 I.R.B. 10.

[36]Panhandle Eastern, supra, n. 21.

interpretation of the ruling that for any point in time there will be a single price applicable to all Sadlerochit producers. A single price applicable to all Sadlerochit producers results in averaging the entire decontrol benefit over all producers without regard to the benefit actually received by that producer. As previously described, that result was not intended by Congress.[37]

G. If Revenue Ruling 83-124 intends the use of the definition in section 4988(c) in applying section 4996(d)(1) then the Congressional requirement for monthly averaging by Sadlerochit producers may be unnecessary.

Revenue Ruling 83-124 implies, without specifically so stating, that the definition of removal price contained in Section 4988(c) should be given effect when construing the provisions of Section 4996(d)(1). Were this to be true then a Sadlerochit producer who does not sell on the premises would be required to use the constructive sales price under Section 613 as the removal price for windfall profit tax purposes. The constructive sales price under Section 613 would be the representative market or field price which has been determined by the Courts to be a weighted average of actual prices paid.[38] Since the representative market or field price is already an average, the requirement of Section 4996(d)(1) for further averaging is unnecessary. Congress does not engage in futile acts[39] nor should legislation be interpreted so that any provision has no meaning.[40] If this is the interpretation intended by Revenue Ruling 83-124, it is improper and gives no effect to Section 4996(d)(1).

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[37]See discussion of the purpose of the tax in Section A, supra, and quotations at n. 33 and 34.

[38]Shamrock Oil & Gas Corporation v. Commissioner, 346 F.2d 377 (5th Cir., 1965); Hugoton Production Company v. U.S., 349 F.2d 418 (Ct. Cl., 1965).

[39]Davies Warehouse Co. v. Bowles, 321 U.S. 144 (1944).

[40]Revenue Ruling 59-56, 1959-1 C.B. 737.

H. Revenue Ruling 83-124 implies that section 4996(d)(1) is a general rule which is obviously incorrect.

It is axiomatic that the specific controls the general.[41] Yet the question presented by Revenue Ruling 83-124 seems to be what is specific and what is general. There is an implication, if not an absolute statement, in Revenue Ruling 83-124 that Section 4988(c) is the specific controlling rule on determination of removal price thus relegating Section 4996(d)(1) to the status of a general rule. If this is the meaning of Revenue Ruling 83-124, we cannot agree with this interpretation.

Section 4996(d)(1) clearly addresses only one property in the entire United States while Section 4988(c) is applicable to all other properties. Section 4988(c) is even referred to as the general rule in the first sentence of the Law and Analysis section of Revenue Ruling 83-124. Considering the unique circumstances surrounding the Sadlerochit reservoir which were known to Congress and the special attention given to this property during the legislative process, there is no way to reach any conclusion other than that Section 4996(d)(1) is the special rule, not Section 4988(c).

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[41] Bulova Watch Company, Inc. v. U.S., 365 U.S. 753 (1961).

I. If Revenue Ruling 83-124 means the use of representative market or field price as removal price for Sadlerochit producers, it will lead to difficult problems of administration for all affected taxpayers.

Representative market or field price is a concept which has only been addressed by the Courts in the context of natural gas production.[42] It has never been applied by the Courts to the production of crude oil. The reason for this lack of judicial authority lies in the fact that crude oil production and natural gas production are marketed in totally different fashions. Natural gas production is generally sold under long term contract with the price stated in the contract subject to escalation or not as the parties may agree. Because the existing judicial interpretations of representative market or field price do not involve crude oil, the disposition of which is factually different from natural gas, it is questionable whether the existing authorities have any application to crude oil production.

But if the existing authorities do apply, and in view of the uniqueness of the facts related to Sadlerochit production as described above, the use of representative market or field price as the removal price for windfall profit tax purposes will require Sadlerochit producers to determine a weighted average value on the North Slope despite the absence of posted prices. In determining such a value the producers will not have access to the price information of other producers who may have disposed of Sadlerochit oil either on the North Slope or in more distant refining areas. Without such information, North Slope producers

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[42]See Shamrock, supra, n. 38; Hugoton, supra, n. 38; Panhandle Eastern, supra, n. 21.

will be unable to properly compute and pay their tax with a timely filed return. These practical considerations were raised in the context of gas production with the following response by the Court of Claims:

> We do not have the slightest doubt that the time and money expended to amass the information is beyond the capabilities of taxpayers generally and does not lend itself in any sense to a workable taxing scheme.[43]

But having recognized the impracticalities of the representative market or field price system for gas production, the Court left an alternative solution to the regulatory power of the Commissioner. In the large majority of cases, oil production is not subject to the same ambiguities in determining representative market or field price because of the existence of posted prices. However, in the case of Sadlerochit oil production where no posted price exists, Congress provided the alternative to representative market or field price in order to avoid the problems recognized in Hugoton. Any use of representative market or field price for Sadlerochit production could conceivably result in lower current deposits of windfall profit tax simply because the application of the representative market or field price concept to Sadlerochit oil production is so ambigious and unclear as to be incapable of practical application.

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[43]Hugoton, supra n. 38.

J. Revenue Ruling 83-124 should be withdrawn with a clear indication that Section 4988(c) has no application to Sadlerochit oil. A new ruling should be considered adopting the special rule of Section 4996(d)(1) as explained by the legislative history and applicable to determination of removal prices for oil removed from the Sadlerochit reservoir on the North Slope of Alaska.

It is clear that Revenue Ruling 83-124 does not express the correct view of the law as passed by Congress and may lead to serious problems in the administration of the windfall profit tax as it relates to oil produced from the Sadlerochit reservoir. Modification or clarification of the ruling would still leave an implication that Section 4988(c) may have some application to oil produced from the Sadlerochit reservoir. Since the application of Section 4988(c) to Sadlerochit oil was not intended by Congress, the only remaining alternative is withdrawal of the ruling.

The Internal Revenue Service should issue a ruling providing that the removal prices for Sadlerochit oil under section 4996(d)(1) are to be determined based on the value of each producer's oil at point of disposition or utilization, less the transportation costs to that point, with monthly averaging to prevent inequities to either the government or the producer.

STATEMENT OF EXXON COMPANY, U.S.A.
BEFORE THE
ENERGY, ENVIRONMENT, AND SAFETY SUBCOMMITTEE
OF THE
SMALL BUSINESS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES
ON
MARKETING PRACTICES
DECEMBER 2, 1982

Mr. Chairman, members of the subcommittee, my name is Dick Kiddoo, Marketing Vice President of Exxon Company, U.S.A. I have responsibility for Exxon's Marketing operations throughout the United States.

Our view is that the gasoline marketplace is working and that marketing has never been more competitive. As a result, consumers have more choices at lower prices than they would have had if the decade of pervasive controls had been permitted to continue.

In that light, I would like to review with the subcommittee Exxon's view of these changes in the gasoline marketing environment since decontrol in January of 1981, and how Exxon Company, U.S.A. has reacted to them. I will also cover our views of the impact these changes have had and will continue to have on petroleum marketers at all levels. This, I believe, will help the committee to understand why some marketers are expressing concern about the current environment. I would also like to comment on certain allegations of alleged "unfair" practices that have been raised by some marketers and put forward Exxon's position on each one.

MARKETING ENVIRONMENT

For almost a decade prior to decontrol, petroleum marketers, at all levels, were precluded from making needed changes in operating practices by government controls. During most of that period, petroleum marketers were told by government to whom we could sell, what portion we could supply to each customer, and what prices we could charge. Since petroleum supplies and prices were controlled, jobber, dealer, and refiner margins were largely a function of government regulation, not marketplace competition.

During the latter part of this period of controls, demand for motor gasoline started to decline by about 3.5 percent per year from its peak in 1978 until the end of controls in January 1981. This was due to conservation efforts by consumers and to more efficient automobiles. However, under controls, marketers were not completely free to respond to this decline by adjusting their operating practices.

Since decontrol however, the consumer, and not the government, has been in charge. The declining demand for motor gasoline which began in the late '70s has continued at around 2.5 percent per year through 1982, this time fueled as much by general economic recession as by any other factor. Thanks to a relatively stable political situation in petroleum producing countries, petroleum supplies have been more than adequate to meet this falling demand. Lower demand and increased operating costs have generally reduced earnings for petroleum marketers at all levels. The consumer is enjoying the results of this highly competitive market.

At present, no one has to concern himself about the availability of gasoline when driving his car. Prices of petroleum products have come down. Retail prices of Exxon's gasoline, when adjusted for average inflation, have declined about 12¢/ gallon since decontrol.

Today, gasoline consumers also have a wider range of choices, particularly in gasoline purchasing, than they had during controls. At many service stations, they now have an option of choosing either the convenience of using the credit card or the savings from paying cash. Since many brands now accept all oil company cards, consumers can enjoy the convenience of purchasing on credit at a much larger number of stations than ever before.

Other forms of nonprice competition have also resurfaced from the precontrol days. Gasoline marketing through convenience stores has become a significant part of the marketplace. Many marketers have accelerated modernizing and improving their facilities to make them more attractive to consumers. In Exxon's case, we have spent about $83 million on service station modernization in 1981 and 1982 and will spend an additional $40 million next year.

All of these changes and benefits, lower prices, cash discounts, more choices, greater convenience, and improved facilities, are in response to the one stimulus which has been the key to economic progress in this country - competition. Just as government regulation controlled volumes, prices, and margins in the '70s, the real control is in the hands of the consumer today.

The result has been an extremely competitive environment where marketers at all levels are trying to change the way they do business in order to remain viable within an industry that is steadily skrinking. As a result of this competition, pressure on operating margins at all levels - refiner, jobber, and dealer - are heavier than during controls. All of us in petroleum marketing have had to take a hard look at every aspect of our operations during this period of tough competition. Many have invested in improved retailing and distribution facilities while reducing their total number of service stations, terminals, or bulk plants. Other marketers withdrew from unprofitable areas while consolidating their operations into the areas of the strength. Everyone has paid more attention to controlling their operating costs. Had these and other steps not been taken within the industry to improve operations and control costs, the consumer would certainly be paying more for gasoline today.

At Exxon since 1974, we have reduced the expense of operating our gasoline marketing business by 36 percent in real terms. A major portion of this improved efficiency was accomplished by upgrading the capacity and effectiveness of our facilities, while not replacing many of our dealers who voluntarily left inefficient service stations.

In some markets, we have also changed our method of operation from supplying the area directly from our facilities, to supplying it through a jobber. These changes were made because we realize that, in some areas we simply cannot operate as efficiently as can a jobber. At present, about 34 percent of our gasoline sales are made through branded distributors, compared to only 10 percent in 1972.

We have also taken some modest steps toward a geographic restructuring of our business. We announced the withdrawal of our marketing operations from several states where we are at a competitive disadvantage. We have also scaled back

refinery runs at our Bayway, New Jersey, refinery to minimize our production through older, less efficient equipment.

More recently, we have implemented our Discount for Cash program on a nationwide basis to allow our dealers and distributors to be more competitive for this cash customer. Under this program, we simultaneously instituted a 3 percent processing fee on credit card tickets submitted by dealers and jobbers and cut our dealer and jobber buying price by an amount to offset, on average, the 3 percent fee. The thrust of our program is to encourage Exxon branded retailers to become competitive by offering a discount to customers who pay cash.

The results of this program are most encouraging, with about 80 percent of our direct-served and about one-half of our jobber-served stations participating. The cash discount most typically offered is 4¢/gallon, and consumer reaction to the program has been very good. Test market surveys have shown 90 percent of consumers sampled had favorable comments.

All these actions combined have made Exxon a more efficient marketer, and the ultimate beneficiary has been the consumer. This consumer benefit is the critical issue and thus is the point that should be the primary concern of the Congress.

MARKETING ISSUES

Any industry operating in a free market and particularly one faced with declining demand will have its share of companies that fail. Many of the companies that remain will also suffer from reduced earnings as they compete for a share of the market. Petroleum marketing is no exception. In this environment, it should not be too surprising that some marketers are looking for a return to "the good old days" when margins all through the system were wider. The fact that these "good old days" included government regulations and controls prompts some to equate a less traumatic business environment with those regulations, and thus to urge re-institution of those regulations which helped that market segment.

I submit that the refiner/marketer is not the cause of the problem, and legislation restricting refiner/marketer operating practices will not result in the cure that is sought. In this regard, I would like to review with you some of the allegations being made by a few marketers and some of their proposed remedies.

SUBSIDIZATION WITH UPSTREAM PROFITS

Let's start with the charge of subsidization of downstream operations with upstream profits. Some independent marketers allege that major brand refiner/marketers are too competitive and price products to their branded dealers and jobbers too low. They believe that majors, such as Exxon, are not efficient enough to price competitively with them unless they subsidize their downstream refining and marketing operations with profits from upstream production.

We certainly recognize that the independent marketer is efficient. This efficiency over the past decade has enabled the independent marketer share of the gasoline market to rise from 28 percent in 1972 to 35 percent in 1981. But some time ago, we also recognized that we had to become more efficient ourselves in order to retain the viability of both Exxon's and our dealers' business. The efficiency improvement I just outlined, not alleged subsidization, are the reasons why Exxon is more competitive today.

The subsidization alleged simply does not hold water. In recent years, my company has consistantly ploughed back, with exploration and production investments, more money than it earned from the production of crude oil. Even so, our refining and marketing business segment has been a substantial purchaser of crude oil supplies at prices set by the market. Our public reporting regularly shows earnings for our separate business segments, and transfers of crude oil from the producing segment to our refineries are audited for state and federal tax purposes.

Today, the charge is that Alaskan crude is providing excess profits through preferential tax and tariff treatment that are used to subsidize the downstream. The suggested remedy is repeal of the WPT exemption for some Alaskan crude oil. Speaking for Exxon, this is simply not the case. First, the small but justifiable adjustment in the TAPS pipeline rates used to calculate the WPT was recently repealed. Second, most Alaskan crude - all of Exxon's - is subject to the Windfall Profits Tax at the 70 percent rate just like other domestic oil from pre-1979 discoveries. Only about 5 percent of industry's Alaskan production, currently, I believe, less than 100,000 barrels per day, is exempt from the WPT. Because the production of this exempt oil was begun only recently and crude prices are currently depressed, we believe no WPT would be due from its producer even if the production were not exempted. Longer term, this exemption is vital to the continuing exploration in clearly-defined exemption area, which covers an extremely hostile environment north at the Arctic Circle and remote from the Alaskan pipeline. In other words, repeal of this limited exemption would do nothing to current operation, but would send clear and damaging signals to those preparing to explore some of the likeliest, but most hostile geography on earth.

What some perceive as subsidization at a specific point in time, may, in fact, be the exercise of an earned competitive market advantage by a particular supplier. The free enterprise system, through profit incentives, creates a natural stimulus for competitors to optimize the operations that can give them a competitive edge. Some suppliers have, over the years, developed an advantageous crude mix. Still other suppliers have invested heavily to hi-grade refineries so they can economically process lower cost crudes. Some companies have focused on improving the efficiency of their marketing operations through strict cost control, pruning of inefficient operations or markets, and improvements in facilities. Many companies have combined several of these and other steps to help them compete.

Another suggested remedy for alleged subsidization is divestiture. Some trade associations are suggesting that divestiture by major oil companies of certain segments of their businesses would solve their concerns. It is not clear as to what would be divested (e.g., service stations, marketing, marketing and refining, etc.) or how the divestiture would take place. But, if a form of divestiture were to be applied and resulted in chaotic market conditions and new and perhaps unforeseen problems, there would be no way to return to the previous conditions. It would be impossible to return asset ownership to former owners and equally impossible to return all the affected employees and consumers to their former situations.

JOBBER/DEALER PRICE DIFFERENTIAL

Some major brand distributors have also leveled charges at their suppliers. Through their associations, jobber groups claim that majors have unfairly reduced the so-called "jobber differential" by raising the branded Distributor Buying Price (DBP) on motor gasoline in relation to the Dealer Transport Truck Price

(DTT). In the competitive climate prior to price controls, Exxon established DTT motor gasoline prices by geographical areas. These prices were based on competitive market forces, including other suppliers' prices in the same trading area tempered, obviously by the cost of supplying product to that area. Exxon individually negotiated DBP motor gasoline prices based on competitive conditions in various distributor market areas and not on a fixed differential versus DTT. During price controls, the difference between DBP and DTT was essentially frozen by DOE. Now that we are again operating in a market free of controls, Exxon's DBP and DTT motor gasoline prices are determined by the respective marketplaces.

Exxon is not involved in predatory pricing or any pricing practice aimed at harming distributors.

There is no fixed relationship between the DTT and the DBP, though they are related in terms of similar, but not identical, competitive factors influencing the two classes of trade. Exxon does not guarantee a specific differential between the two prices but sets its DBP and DTT prices in response to competitive conditions. Except during price control periods, the price difference has varied with competitive pressures at different levels in the distribution chain. In addition, the difference has changed as Exxon has altered its approach to charging for the services included in the price, such as credit cards.

Distributor buying prices are primarily influenced by rack prices. If the price to a major brand distributor is too high relative to the rack price, he cannot compete. If it is too low, he is in a position to assume the rack function and profitably broker product as long as his supplier makes it available.

Despite the narrowing of the differential, there has been no rash of business failures among Exxon jobbers. On the contrary, only four Exxon jobbers have become insolvent since 1979.

COMPANY-OPERATED SERVICE STATIONS

The relatively few stations operated by some majors, including Exxon, appear to be the next most common area of allegation. Both jobber and dealer groups claim that retail prices at major brand company-operated service stations are so low that they cannot compete and still maintain a satisfactory margin. One remedy they seek is retail divorcement.

In establishing motor fuel prices at a company-operated service station, it is Exxon's practice to post retail prices which allow us to compete effectively with key competitors in the trade area.

Exxon sets retail prices at company-operated service stations in response to competitive conditions prevailing at retail in the trading area. Jobbers and dealers who elect to compete for business in a market where prices are depressed must expect a reduced margin along with other competitors.

Exxon believes Retail Divorcement would be a very severe and illogical solution to correct the allegations of unfair practices, most of which are unrelated to direct refiner operations. Major oil company salaried service stations represent a small portion (3 percent) of the total U.S. service station chain (5 percent of volume in '81). It is very difficult to understand how this small segment of the market can be a threat to jobber or dealer-operated stations.

SERVICE STATION RENT

Dealer associations also claim that the majors are trying to drive them out of business and operate their stations directly. Majors are allegedly making the dealers' business unprofitable through unreasonable and ever increasing rents.

Here again, the facts do not fit the charges, nor are the alleged results visable. Exxon's dealer rents have, on average, increased about 8 percent per year since 1977. We do not believe this increase is unfair in light of several factors. First, prior to controls, dealer rents were very low. During most of the period of controls, only minor increases in rents were allowed. However, during this period, property values increased dramatically. Thus, as we started to come out of controls, our return on our real estate investment was unrealistically low. Even with the increases that have taken place, we are now achieving 9.2 percent return before income taxes on the value of our real estate investment. Our rentals do not vary with gallonage throughput; this was a source of contention with dealers in the past.

To allege that we are trying to drive dealers out of business in favor of company-operated stations is economic nonsense. Company stations have declined markedly from 13 percent of our branded chain in 1970 to only 3 percent today. Dealer attrition - that is dealers leaving and being replaced by new dealers - in 1982 is at 70 percent of the 1981 rate and only one-half of the average rate of dealer attrition for the period 1974 through 1980. Less than one-third of those dealers leaving stations in 1982 have done so because of competitive or economic reasons.

CREDIT CARD MERCHANT'S FEES

The next change in marketing practices that is objectionable to some marketers is the trend toward credit card processing fees. Dealers and jobbers claim that oil companies have instituted credit card ticket processing fees in order to shift the cost of credit from the oil company to the retailer. The remedy proposed is legislation to prohibit oil companies from charging these fees.

Some background as to how Exxon has attempted to recover the costs of its credit card programs in the past may aid in understanding this issue. Historically, these costs have been recovered in the wholesale price of gasoline, and service station dealers and distributors passed the cost of credit cards along to their customers. Under this system, dealers and distributors made the same gross profit on credit and cash sales. Thus, the credit and cash customer shared the cost of the retail credit system, or said another way, the cash customer subsidized the credit customer.

The cost of Exxon's credit card program in 1972 was about 2¢/gallon. Because of rising gasoline prices and dramatically higher interest rates, the net cost is now 4-6¢/credit gallon. Finance charges on late payments and extended credit terms are paid by only a small percentage of Exxon credit card customers.

The cost of credit is simply too high to be passed along in the wholesale price of gasoline and still allow our dealers and distributors to be competitive in the marketplace for the cash customers who buy some 70 percent of the gasoline sold in this country.

Exxon is now encouraging dealers and distributors to offer discounts for cash. This is accomplished by initiating a merchant's fee charged to the dealer or distributor for credit card tickets submitted for reimbursement. At the same time, wholesale buying prices for gasoline are reduced by an amount sufficient, on average, to offset the merchant's fee.

Since the dealer segment has a higher percentage of credit card sales than the distributor segment, their buying price reduction had to be greater than that of distributors in order to offset the merchant's fee. In both cases, however, the reduction was sufficient to offset the merchant's fee expected to be charged to that class of customer.

Retailers can pass along the price reduction to their cash customers in a lower discounted price while the price paid by the credit card customer includes the cost of credit.

By offering the lower cash price, dealers, including those served by branded distributors, can compete more effectively in the marketplace for cash customers while continuing to offer credit customers the convenience they seek for a price that is commensurate with the credit service they receive.

It should be noted that some distributors, as well as some dealers, would prefer to add a credit surcharge to their base cash prices rather than offering a discount for cash off their credit prices. However, the Truth in Lending Law specifically prohibits sellers from imposing a credit surcharge.

We believe that credit card merchant's fees are equitable to dealers and distributors as well as to cash and credit customers. The cost of the credit card has been shifted from all customers to only those customers who want to avail themselves of the convenience of credit service. Legislation to prevent credit card merchant's fees would require the implementation of a less desirable means of competition for the cash customer and could result in the elimination of the credit card. Consumers and marketers at all levels of distribution would be hurt by such legislation.

It is clear that different companies have chosen different approaches to the problem of credit card costs. We don't yet know how the market will evolve in this area, but it should be the consumer, not the Congress, not the dealers, and not the suppliers, who makes the final decision.

While these four complaints; shrinking jobber/dealer differentials, company-operated service stations, subsidization, and credit card merchant's fees, are the most talked about areas, there are also a number of other issues raised by jobber groups that I would like to bring to the subcommittee's attention.

VOLUME LIMITATIONS

Jobber groups also claim that majors have unfairly restricted motor gasoline supplies to jobbers while providing unlimited supplies to dealers served directly.

Since decontrol, Exxon has continued to supply its customers' fuel requirements in a fair and equitable manner. Exxon has executed sales contracts with its fuels customers that either specify volumes or a method of determining volume based on historical performance. In the event that it should become necessary to allocate motor gasoline supplies, these sales contracts should provide the basis for any company allocation program.

During the second quarter of 1982, gasoline supplies were temporarily short in some markets, and some Exxon distributors requested volumes in excess of contract maximums. These requests could not be honored in all cases. Claims were made that Exxon was allocating gasoline to its distributors but not to its dealers. This charge apparently stemmed from a combination of unusual events. During the period April through June of 1982, Exxon's distributor buying price was at times below the average rack price by more than 1¢/gallon because of a temporary tight supply situation in the spot market. Not surprisingly, many Exxon distributors took advantage of the situation and drew abnormally high volumes of gasoline, some of which may have been brokered. As a result, Exxon's sales to distributors increased 26 percent versus the same April-June period in 1981, while sales to dealers decreased by 3 percent compared to the same time period.

In response to this situation, Exxon decided to limit gasoline supplies in June to its distributors to 100 percent of contract. This restriction was not applied to dealers because dealer sales volume was below the previous year's levels. The tight supply condition was fortunately short lived (in other words, the market worked), and eased about the time the decision was made; and as the rack price declined, so did the need to limit distributor purchases except in a very few markets. The decision to limit distributors to contract volumes was consistent with applicable provisions in their supply agreements and with good business practices.

SOLICITATION OF JOBBER ACCOUNTS

Additionally, jobber groups claim that majors are soliciting jobber dealer and commercial accounts in order to supply them direct. Once again, with Exxon, this is not the case.

Over the past ten years, the uninterrupted trend in the method of serving Exxon branded service stations shows increasing numbers of jobber-served retail outlets (from about 5,800 to almost 12,000) and decreasing numbers of direct-served retail outlets (from over 22,000 to about 8,400). As mentioned earlier, Exxon branded jobber motor gasoline sales rose from 10 percent of total Exxon volume in 1972 to over 34 percent in the first half of 1982.

Over the last few years, Exxon's number of commercial/industrial motor fuel accounts has remained approximately the same; however, the volume to the these accounts has decreased dramatically. In addition, Exxon's direct sales of heating and diesel fuels to commercial/industrial accounts has also decreased.

Exxon does not actively solicit Exxon jobber service station accounts. With regard to industrial/commercial accounts, Exxon's current practice is to serve direct only those that offer sufficient volume to make such accounts economically attractive. In pursuing this practice, Exxon does not actively solicit jobber accounts, but may respond to a jobber customer's request to be served direct, or may submit a bid on business for which a jobber may also be bidding. To deny a request to bid, in order not to compete with an Exxon jobber, would be a questionable business practice, if not restraint of trade.

While the general policy is to sell product at posted prices, Exxon may choose to meet a lower competitive price. Exxon believes a decision to respond to such competition should not be forestalled because there are Exxon jobber operations in the market. Furthermore, Exxon does not attempt to limit the disposition of

product sold to its jobbers. Exxon and its jobbers may, therefore, compete against one another for a given commercial/industrial account that is attractive and within the service capability of each.

MARKET WITHDRAWALS

Finally, jobbers are concerned that market withdrawals will disrupt supplies, adversely affect the jobbers of the withdrawing company, and reduce competition to the detriment of consumers. However, our view is that selected, legitimately implemented withdrawals are necessary adjustments which, in many cases, are long overdue because of controls.

The concern that withdrawals will cause supply disruptions is not supported by historical precedent. For example, following the decontrol of heating oils in 1976, some suppliers did elect to withdraw from certain uneconomic heating oil markets. However, other suppliers absorbed the business formerly served by the withdrawing suppliers. Furthermore, these markets were then able to effectively and efficiently meet the supply challenges created by subsequent severe cold winters.

Historically, motor fuel suppliers have entered new markets and withdrawn or curtailed operations in existing markets in response to normal competitive forces. These withdrawals have occurred without significant interruption of supply to consumers and with minimal disruption in supply availability to economically viable dealers or jobbers. When marketers have elected to leave a market, the more efficient suppliers that remained typically have met consumer demand requirements and filled potential supply voids. Resulting efficiencies probably have lowered total marketing cost and, therefore, kept prices to consumers in that market lower than they otherwise might have been.

Exxon believes that limitations on market withdrawals are unnecessary and an undesirable restraint on legitimate business decisions. The free market mechanism should be permitted to operate, as experience has proven that other suppliers will take over any economically viable business handled by the withdrawing marketer. The acquisition of additional business tends to strengthen those suppliers and their customers, and make their operations more efficient with potential price benefits to consumers.

SUMMARY

In summary then, just as the charges and allegations of "unfairness" made by some marketers represent the workings of a free, competitive marketplace, so the remedies proposed would hinder and not help that marketplace to function. It should be obvious that major brand refiner/marketers in general, and Exxon in particular, cannot simultaneously be taking unfair advantage of all other market participants. Yet, if you total up all the testimony you have heard and articles you have read, that is what is charged.

Accordingly, I submit that what is happening to marketers at all levels is simply the way that a competitive market system is supposed to work. It is a system which encourages tough competition - and puts heavy pressure on profit margins - to give the consumer the best possible product and service at the lowest possible price. It is a system that is tough on sellers at all levels, and Exxon is certainly not immune. Many dealers and jobbers claim their profits have fallen. So have Exxon's!

The way to higher profits - indeed, in our business, to continued survival - is greater efficiency and better products, sold in a competitive marketplace - not more regulation and legislation. The gasoline market in this country, since January 1981, is a textbook example of a free market that is working. It is difficult for all of us participating in it - no one can deny. But, it should be made equally clear that any legislation enacted to protect any segment of the market from competition will be at the expense of the consumer.

APPENDIX F.—PRESS ARTICLE ON ANS CRUDE OIL COST FACTORS

ALASKAN OIL PROFITS HOLD STEADY DESPITE FALLING PRICES

The big drop in oil prices is not hurting Alaskan North Slope producers so far. Thanks to the tax structure, the U.S. and Alaska governments have absorbed the entire $7.50 to $8 a barrel price drop since early 1981, keeping producers' profits steady at over $5. Despite Alaska's status as a frontier producing area, there is still room for further price cuts if down-pressure starts again in international oil markets, PIW finds in updating its economic profile of Alaskan North Slope production (PIW, March 16 1981 p. 3). Delivered prices could fall to about $12 per barrel at bare-bone production and transportation costs, with zero profit. Overall government take has fallen from about $18 at the peak price in 1981 to just $10 now—squeezed by lower prices, just as it soared with the price explosion. PIW's analysis focuses on average Prudhoe Bay production subject to the full brunt of tax obligations.

In future, however, the producing companies will bear a much larger share of any price cuts that might eventualize. They also face a squeeze on profit margins due to higher production costs. Currently those costs are estimated at 95¢ a barrel, but they are likely to rise sharply as enhanced recovery projects begin next year.

Profits were sheltered from declining prices mainly by the U.S. windfall tax, but its effect is now negligible for the North Slope. In fact, for Gulf and East Coast deliveries the tax has dropped to zero, marking the first time a large share of U.S. output has slipped below the so-called "windfall floor" (PIW) March 29 1982, p. 7). For West Coast sales the windfall tax has dropped from almost $7 a barrel to $1 as the declining wellhead price converged with the rising tax floor. State tax obligations also declined in 1982.

It now costs about $3 a barrel more to move Alaskan crude to the Gulf Coast than to the West, but profit margins on the oil differ by only 10 cents. On average, sales prices differ by $1 to $2 between the two markets. Most of the rest of the difference comes from heftier taxes on the West Coast sales due to higher wellhead realizations. The new trans-Panama pipeline, built especially for Alaskan crude, reduced average costs for moving oil to the eastern U.S. by about 40 cents a barrel. Over the last two years the volume of Alaskan crude moving to Atlantic destinations has jumped to 50% of shipments (PIW May 9, p. 14).

Delivered West Coast prices reported by producing companies have diverged markedly since 1981. Sohio's contract prices at times have been more than $1 above the average for all firms. This gap reflects differing company appraisals of West Coast crude values (and is the subject of inquiries by tax authorities). As the largest arms-length seller of North Slope crude, Sohio has treated the Gulf and West Coast markets independently, generally trying to get the highest prices possible in each. This meant sometimes losing customers on the West Coast (PIW Oct. 18, p. 5). By contrast, Arco has regarded the Gulf Coast as the price-setting market of last resort. It also considers prices must be competitive with locally produced crudes, which implies a lower West Coast price.

In addition to sizable earnings on production, companies also continue to make healthy profits on transporting crude through the trans-Alaska pipeline as well as carrying it on their own tankers. Pipeline profit estimates range from $1 to $3 or more, depending on how the line's cost is calculated and amortized.

THE COMPARATIVE ECONOMICS OF ALASKAN NORTH SLOPE CRUDE PRODUCTION (In dollars per barrel)

	Sales To US West Coast						Sales To US Gulf Coast					
	1983	1982		1981			1983	1982		1981		
Delivered Price	Current	4th Q	3rd Q	1st H	2nd H	1st H	Current	4th Q	3rd Q	1st H	2nd H	1st H
Sohio Price	26.50	29.17	29.50	28.71	31.44	33.77	27.00	30.17	30.75	29.30	32.35	34.02
Average Price(a)	25.75	27.74	28.29	28.03	30.51	33.15	27.00	29.98	30.41	29.40	32.23	34.99
Less:												
Shipping Cost	1.46	1.48	1.49	1.43	1.28	1.39	4.40	4.44	4.47	4.86	4.58	4.70
Valdez f.o.b.	24.29	26.26	26.80	26.60	29.23	31.76	22.60	25.54	25.94	24.54	27.65	30.29
Less:												
Liability Fund	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Pipeline Loss	0.10	0.11	0.11	0.11	0.12	0.12	0.11	0.12	0.12	0.12	0.13	0.14
Pipeline Tariff	5.95	5.95	5.95	5.95	6.20	6.20	5.95	5.95	5.95	5.95	6.20	6.20
Wellhead Price	18.19	20.15	20.69	20.49	22.86	25.39	16.49	19.42	19.82	18.42	21.27	23.90
Less:												
Royalty(b)	2.19	2.43	2.50	2.48	2.78	3.10	1.98	2.34	2.39	2.22	2.58	2.91
Severance(c)	2.40	2.66	2.73	2.70	2.31	2.56	2.18	2.56	2.61	2.43	2.15	2.41
Property Tax	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17
Producing Cost	0.95	0.95	0.95	0.95	0.85	0.85	0.95	0.95	0.95	0.95	0.85	0.85
Depreciation(d)	1.10	1.10	1.10	1.10	1.00	1.00	1.10	1.10	1.10	1.10	1.00	1.00
Pre-Tax Profit	11.38	12.84	13.24	13.09	15.75	17.71	10.11	12.30	12.60	11.55	14.52	16.56
Less:												
State Income Tax(e)	0.34	0.38	0.40	0.39	1.48	1.66	0.30	0.37	0.38	0.35	1.36	1.56
US Windfall Tax(f)	1.00	2.37	2.85	2.93	4.89	6.80	0.00	1.93	2.33	1.69	3.91	5.87
US Income Tax(g)	4.62	4.64	4.59	4.49	4.31	4.25	4.51	4.60	4.55	4.37	4.25	4.20
Profit	5.42	5.45	5.40	5.28	5.07	5.00	5.30	5.40	5.34	5.14	5.00	4.93

a) Average for all producers. b) Royalty 12.5% after deduction of gathering allowance (68¢ 1983, 67¢ 1982, 62¢ 1981) c) Severance tax 15% of wellhead price after deduction of royalty; 11.5% in 1981. d) Includes depletion and amortization. e) Effective state income tax rate of 3% since 1982; 9.4% in 1981. f) Windfall tax rate of 70% (PIW March 10'80 p.3). g) Tax rate 46% after deduction of costs, state taxes and Windfall tax.

APPENDIX G.—CRS REPORT ON REVENUE RULING 83-124

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

WINDFALL PROFITS TAX: BACKGROUND AND EFFECT OF REV. RUL. 83-124

Thomas B. Ripy
Legislative Attorney
American Law Division
September 13, 1983

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

September 13, 1983

TO : House Small Business Committee
Attention: Mark Levine

FROM : American Law Division

SUBJECT : Windfall Profits Tax: Background and Effect of Rev. Rul. 83-124

Pursuant to your request of August 22, 1983, we have prepared the attached report on the above captioned subject. If we can be of further assistance, please contact us.

Thomas B. Ripy
Legislative Attorney

WINDFALL PROFITS TAX: BACKGROUND AND EFFECT OF REV. RUL. 83-124

The Crude Oil Windfall Profit Tax Act of 1980 (Pub. L. No. 96-223) imposes an excise or severance tax on windfall profits from domestically produced crude oil. Under the provisions of that Act, the tax is levied on the windfall profit, which is the difference between the removal or selling price of the oil and the adjusted base price plus an adjustment for the State severance tax on the windfall profit.[1/] For purposes of the tax the Act divides crude oil into three tiers with varying tax rates and adjusted base prices. Oil from the Sadlerochit reservoir on the Alaskan north slope (hereinafter ANS oil) is taxed in tier one (the highest rate and lowest adjusted base price).[2/] In the case of Sadlerochit or ANS oil, a controversy has arisen as to how that removal price is to be calculated in the absence of any wellhead sales, which would generally be used to establish the removal price under § 4988(c) of the Internal Revenue Code. When, however, the crude oil is removed from the premises or sold to a related person, that section provides that the removal price is to be equal to the amount that results or would result from the application of the constructive sales price principles under IRC § 613 for determining gross income from the property.

1/ IRC § 4988. The tax is phased out. IRC § 4990.

2/ IRC §§ 4987, 4989.

Since the tax is levied on the difference between removal price and adjusted base price, taxed at 70 percent for first tier oil, the method used to determine the constructive sales price at the wellhead is significant for tax liability. If one method produced a removal price of $26.50 a barrel and another $29.50, the tax difference is $2.10 a barrel, or $630,000 a day if 300,000 barrels per day are removed.

In the case of Alaskan North Slope Oil the three major oil producers use different methods for determining the removal value of ANS oil. Sohio sells or exchanges most of its ANS oil and uses the value received in these third party transactions as the starting point for valuation. From this it subtracts its transportation costs, marine and pipeline, to determine the ANS removal price. Its marine transportation is by tankers under long-term and short term charter, the former operated by outside parties under contract.[3/] Exxon uses a series of different destination prices, using

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3/ Windfall Profits Tax: Hearing before the Subcomm. on Oversight and Investigation of the House Comm. on Energy and Commerce, 98th Cong., 1st Sess., 14-15 (1983) [hereinafter cited as 1983 Hearings]. The focus of the hearing was concisely stated in Chairman John Dingell's opening remarks (Id. at 1):

> The allegation has been raised that producers of crude oil from the North Slope of Alaska are evading millions of dollars in windfall profit taxes and Alaska State severance taxes. In view of the fact that this involves energy policy within the jurisdiction of this committee and involves also events which transpired over a period of years covered in part by price controls on crude oil and refined products, it appears this is a matter into which this committee should inquire.
>
> It has been further alleged that the money that should have gone to the Treasury has instead been used to reduce petroleum product prices in an effort to drive independent jobbers and retailers out of business.

(continued)

third party sales for value, where such sales are made, and an assessment of market value based on posted prices, their own transactions, and other publicly available market data in the area ANS is refined, when they refine it themselves. Transportation costs are subtracted and prices weight averaged for volume shipped to each market on a monthly basis to determine removal value. Approximately 70 percent of marine shipping is by chartered tanker.[4/] Arco uses a single reference price based on the posted field price of West Texas Sour crude, adjusted for quality differences and the cost of piping the Texas crude to the Gulf coast. From this Arco subtracts the cost of transport from the wellhead to the Gulf Coast to determine removal price for ANS crude. Approximately 70% of their transportation is in their own tankers. The cost of transportation on their own ships is computed by a rate average calculated for Arco by an outside agency, under contract originally and now provided by subscription.[5/]

The controversy which has arisen in this area has centered upon the removal price for ANS oil as calculated by Arco. At congressional hearings held in 1982 and 1983, competitors of Arco alleged that Arco has undervalued its ANS oil, underpaid its windfall profits tax as a result, and utilized its tax savings to selectively lower prices in certain pricing zones to

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(continued) It is no secret that these accusations have been leveled primarily at the Atlantic Richfield Co. It is equally obvious that the complaints stem primarily from Arco's competitors, whose economic interests are totally opposed to those of Arco. Both sides are present and can speak for themselves. It is the intent of today's hearing to try and get to the bottom of these questions.

4/ 1983 Hearings 10-11, 35.

5/ 1983 Hearings 4-7, 38-39.

unreasonable levels and drive independent competitors (retail outlets and suppliers) out of business. In support of these charges some witnesses maintained that ARCO dealers in certain areas were selling gasoline at prices below the price paid for crude by certain other refiners in those areas, while ARCO still shows a profit at all levels of operation. This, it was said, cannot be explained by efficiency, but can only be understood as a product of tax savings from undervaluation of the wellhead prices of its ANS crude and the resultant tax savings.[6/]

It has been suggested that all three major producers, who also own an interest in the Alaskan pipeline, may benefit from cost allocation to pipeline transportation.[7/] Much attention has been directed toward the marine transportation costs used by Arco, since the bulk of ANS crude is carried in its own tankers. Essentially, it is argued that, by using the single price reference of West Texas Sour on the Gulf Coast reduced

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6/ Gasoline Marketing Since Decontrol: Hearings before the Subcomm. on Energy, Environment, and Safety Issues Affecting Small Business of the House Comm. on Small Business, 97th Cong., 1st Sess. 199-213 (1982) [hereinafter 1982 Hearings] esp., the testimony of Jack Blum Counsel, Independent Gasoline Marketers Council, who called for IRS action to allocate transportation costs. Id. at 205. These hearings were much broader in scope than the 1983 hearings. In his opening statement Chairman Berkley Bedell indicated they were called in response to numerous requests to investigate a variety of problems in gasoline marketing and were intended to establish a record of the situation in various areas, identify the problems, and consider what might be done. Id. at 102. 1983 Hearings 45-92, testimony of Jack Blum, Counsel, Independent Gasoline Marketers; R. Timothy Columbus, Counsel, Society of Independent Gasoline Marketers of America; Phillip R. Chisholm, Executive Vice President, National Oil Jobbers Council, See esp. p. 50 on allegation of gasoline price below the prevailing cost of crude in certain areas.

1982 Hearings 200, 204; 1983 Hearings 46. According to testimony in t later hearing ARCO's pipeline tariff was $6.04 compared to $5.50 per barrel average. ARCO noted that its rate was the lowest at $6.04 for 4 1/2 years, others had lowered tariffs, and the rate actually paid by ARCO was a composite that actually fell below $5.50. In response Mr. Blum suggested that the issue was the reasonableness of any tariff rate. 1983 Hearings 100-101.

by transportation costs, ARCO is able to undervalue ANS crude wellhead prices.[8/] This charge of inflated transportation costs was raised in hearings before the Subcommittee on Energy, Environment, and Safety Issues Affecting Small Business in December of 1982 and elaborated upon in testimony before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce in February of 1983. In the latter hearing questions were raised as to the incremental shipping costs to the Gulf coast, as opposed to Los Angeles. ARCO's figures indicated a difference of $4.16 a barrel, Exxon's about $3.85, and Sohio $2.50 to $3.00 a barrel. The figures for the latter two companies were estimates given by company officials in response to questioning.[9/]

ARCO's reply to these questions challenged the data saying that the lower difference in transportation cost differences might be the result of higher charges to Los Angeles by the other majors or different ship

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8/ A comparison of ANS wellhead prices of Sohio and ARCO for July 1982 through November 1982, based on data from the Oil and Gas Journal and the Alaskan Department of Natural Resources was offered by Mr. Columbus of the Society of Independent Gasoline Marketers of America in support of his allegation that ARCO was obtaining a competitive advantage by undervaluation. The table follows (1983 Hearings 73, citations omitted, gathering charges of approximately 66 cents per barrel were not reflected in these prices):

Monthly Average Crude Oil Wellhead Prices

	Sohio	Arco
July	21.10	18.05
August	21.12	18.72
September	21.41	18.56
October	20.92	18.89
November	21.16	19.60

A staff report calculated the price of ARCO crude on the West coast for the 1st 9 months of 1982 at $26.36 compared to actual sales of ANS crude in that market averaging more than $29 per barrel in that period. Id. at 22.

9/ 1983 Hearings 17, 30-34.

efficiencies.[10] They also indicated the price of their ANS oil on the West coast compared favorably with locally produced crude of similar qualitity. Furthermore, they insisted West Texas Sour was a good marker crude, comparable in quality, produced in large quantities, with posted prices in an established market.[11]

During the course of these hearings, it was suggested that IRS should act to solve the problem by establishing a method for calculating the wellhead price for ANS oil. A number of members of Congress echoed this call.[12] Further fuel was added to the fire with an August 4, 1983, press release from Representative Bill Nelson, discussing a preliminary briefing by GAO on a study being prepared in response to his request in December of 1982, when he was chairman of the House Budget Committee's Task Force on Tax Policy. According to that press release, GAO indicated that methods used to calculate ANS oil wellhead price had resulted in underpayment of $500 million to $800 million a year in taxes. Inflated transportation charges were singled out as the problem areas. "The problem is that some of the companies have been inflating their transportation charges; many of them own their own ships, so they are charging themselves more for the ships and they are understating their profits on the oil at the wellhead where it is taxed."

10/ Id. 32-34.

11/ Id. 5-6, 15-19, 31. The President of ARCO, stated that the delivery price of comparable Buena Vista crude from Bakersfield (posted wellhead on Feb. 2, 1983, plus transportation) was $25.40 per barrel in Los Angeles and ARCO's delivered ANS crude at the same time was $26.19. This, he maintained, illustrated that ARCO's calculations produced comparable West coast prices.

12/ 1982 Hearings 205; 1983 Hearings 58, 83; Representatives Berkley Bedell and Beryl Anthony called upon IRS to issue a ruling clarifying ANS crude pricing methods. "Treasury Asked to Ponder Ruling to Void ARCO Alaskan Oil Pricing Methods" Inside Energy (May 30, 1983).

On August 8, 1983, IRS issued Rev. Rul. 83-124, concerning calculation of the removal price of ANS crude oil. It held that "The appropriate method, as provided by statute, for determining the 'removal price' for Alaskan North Slope crude oil removed from the premises before sale for purposes of the Crude Oil Windfall Profit Tax is the method based on the principles for determining gross income from the property under section 613 of the Code without regard to DOE Pricing regulations for determining first sale price." IRS noted that regulations under § 613 provide that where conversion or transportation occurs prior to the sale, "the gross income from the property shall be assumed to be the equivalent to the representative market or field price of the oil or gas before conversion or transportation." The ruling indicates that any use of a netback method must be consistent with § 613 principles.

Reaction to the ruling was mixed. Among the major ANS producers, only Exxon was critical of the ruling saying that the ruling apparently invalidates its method of calculating taxes without providing explicit guidance as to the correct method. Sohio said that ruling appeared to have no effect on their method of calculating ANS wellhead prices. ARCO claimed that the ruling supported their method, using West Texas Sour to establish a representative or field market price, regardless of where the crude is sold or refined. The Society of Independent Gasoline Marketers of America maintained that the ruling supported their claim that ARCO's method was improper because the West coast market was the appropriate one for establishing a representative price, rather than the separate, more distant Gulf coast market. The National Oil Jobbers Council, in contrast, expressed the view that the ruling did little to clarify the issue with regard to pricing methods.[13/]

13/ Platt's Oil Marketing Bulletin, Vol. 23, No. 32, 1-3 (August 15, 1983).

The ruling does not provide any guidance on determination of transportation costs, which has been a major focus of concern. The ruling does not specifically approve or disapprove the methodology of any of the three majors. Under § 401 of the Energy Policy and Conservation Act of 1975, Pub. L. No. 94-163, 89 Stat. 942, a national weighted average first sale price was calculated, and under the ruling this approach is apparently barred. Because Exxon uses a weighted averaging technique and public pricing and market data from various markets, the ruling does raise questions as to the propriety of their method. Sohio also uses a weighted average, but relies on its actual sales and exchanges of crude as a starting point, since the bulk of its ANS oil is sold or exchanged, and this difference in data might be the reason it feels less threatened by the IRS ruling than Exxon.

In testimony before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce the Senior Vice President of Sohio suggested that the Gulf and West coasts were separate and distinct segments of the U.S. market and indicated that price differences in the two areas were considerably less than differences in transportation costs. The price difference, he said, was generally less than $1 per barrel, while transportation differences, as noted, ranged from $2.50 to $3.00 for Sohio and $4.16 for ARCO.[14/] If that is correct, there is an apparent tax advantage in use of the Gulf coast marker price and netting back transportation costs to determine wellhead price of ANS crude. It should be emphasized

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14/ 1983 Hearings 19. He indicated that if the single reference based price of ARCO had been used by Sohio to calculate West coast Sohio prices, they would have been lower.

that the ruling does not approve or disapprove use of the Gulf coast market as a representative market for that purpose.

A representative or field market price might be established for a producer who transports or refines the oil by using weighted wellhead price averages for comparable oil produced by others in the same field or same geographic area. This technique was followed under § 613, but there is no comparable basis for establishing the wellhead price for ANS crude. Panhandle Eastern Pipe Line Co. v. United States[15/] is illustrative of two techniques used under § 613 for determining gross income. There the Court used a single weighted average for computing the value of natural gas produced from the Hugoton Embayment in Kansas, Oklahoma and Texas in an area selected by the taxpayer and including the three states area where there were a number of producers and common formations crossing state lines. In one field in Michigan, where the taxpayer was the sole producer, a portion of the gas was sold to a third party at or near the wellhead. There the Court of Claims used the price received less stipulated gathering and delivery costs. In Petroleum Exploration v. United States[16/] the court found that no representative or field market price could be established for the particular field involved and turned to the average price for gas in the same general geographic area to establish a representative price, noting that the gas was comparable in quality and the resultant price consistent with Federal Power Commission pricing adjusted for gathering costs, slightly lower than the weighted average sale price of unprocessed

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15/ 408 F.2d 690 (Ct. Cl. 1969).

16/ 404 F.Supp. 93 (N.D. W.Va. 1975), aff'd, without opinion 551 F.2d 508 (4th Cir. 1977).

gas from the field adjusted for gathering and transportation charges, and with a price previously approved by IRS.

What is apparently required is that the market area selected should be representative of taxpayer's production and the sales of comparable oil (or gas) used in the computation.[17/] In the absence of nearby sales or wellhead sales by others in the same field or in the same general geographic area, the type of data used in the cases arising under § 613, discussed above, the problem of identifying an area representative of the taxpayer's ANS production and adjusting for transportation becomes more difficult. The problem is compounded if, as Sohio's testimony suggests, price differences between two geographical markets for ANS crude are not a reflection of differences in transportation costs, and the difference in market price tends to be substantially lower than transportation cost differentials. Presumably, if you have wellhead sales in the same field or general geographic area, the prices obtained and weight averaged would reflect to some degree prospective transportation costs to varying ultimate markets. This would not be the case where the market price used is for comparable crude sold in a single market distant from the producer's field, even if it is assumed the claim for transportation costs is not inflated. Thus, if a single representative market price for ANS crude is required, the questions of what is a representative market and a reasonable allowance for transportation are critical issues, neither of which is addressed by the recent IRS ruling.

Thomas B. Ripy

Thomas B. Ripy
Legislative Attorney
American Law Division
September 13, 1983

17/ 408 F.2d at 706-707.

APPENDIX H.—ADDITIONAL MATERIAL FOR THE RECORD

LAW OFFICES
SHAPIRO, LAUFER, KRANE, JACOBSON & POSELL
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

RICHARD H. CLOSE
LAWRENCE H. JACOBSON*
JULES L. KABAT*
SAMUEL KRANE*
DAVID LAUFER
RICHARD E. POSELL
KENNETH P. ROBERTS*
MITCHELL S. SHAPIRO
ROCHELLE BUCHSBAUM SPANDORF

DOUGLAS L. CARDEN
MARIANNE DOZIER
CAMERON H. FABER
JOHN C. GORMAN
MARK E. LEHMAN
JAMES H. LEHR
PAUL H. LEVINE
DENISE M. ROZELL
BEVERLY S. TILLETT
MARTIN A. WEISS

*A PROFESSIONAL CORPORATION

August 22, 1983

OF COUNSEL
B. D. FISCHER, INC.
MINDA R. SCHECHTER
RAYMOND WALLENSTEIN*

ONE CENTURY PLAZA, SUITE 2800
2029 CENTURY PARK EAST
LOS ANGELES, CALIFORNIA 90067
TELEPHONES
(213) 277-1818
(213) 879-9901

CABLE ADDRESS:
SHAPLAW

TELEX NUMBER
66-4999

Mark Levine, Esq., Counsel
Small Business Oversight Subcommittee
B-363 Rayburn Building
Washington, D. C. 20512

Re: Revenue Ruling 83124

Dear Mr. Levine:

Pursuant to our conversation of Friday, August 19, 1983, enclosed please find:

1. Communication with the Federal Trade Commission, as supplemented, together with enclosures.

2. Communication with the Department of the Interior, as supplemented, together with enclosures.

It is essential that Congressman Bedell's Committee deal effectively with what I believe to be Arco's manipulation of its windfall profit tax. For example, Atlantic Richfield Company's second quarter report, six months ended June 30, 1983, shows a decline in payment of $200,000,000:

> "During the first half of the year, Atlantic Richfield incurred windfall profit tax of $256,000,000 versus $456,000,000 during last year's first half...."

As soon as I receive a copy of Revenue Ruling 83124 I shall make every effort to communicate my client's views on this revenue ruling in a timely manner. Please let me know if my testimony on this subject will be helpful to the Committee.

Sincerely yours,

DAVID LAUFER

DL:dh:M
encs.

LAW OFFICES
SHAPIRO, LAUFER, KRANE, JACOBSON & POSELL
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

RICHARD H. CLOSE
LAWRENCE H. JACOBSON*
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MARTIN A. WEISS

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OF COUNSEL
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2029 CENTURY PARK EAST
LOS ANGELES, CALIFORNIA 90067
TELEPHONES
(213) 277-1818
(213) 879-9901

CABLE ADDRESS
"SHAPLAW"

TELEX NUMBER
66-4999

August 15, 1983

Federal Trade Commission
Sixth and Pennsylvania Avenue
Washington, D. C. 20580

Attn: Mr. Ronald B. Rowe,
Assistant Director

Re: Submission of California Arco Distributors, Inc. and Agents Alliance, Inc.

Dear Mr. Rowe:

I am following up on the submission of my clients dated August 3, 1983 with material from the July 4, 1983 issue of Forbes, wherein it is stated:

> "Whatever the reason, Arco has indeed been gaining market share by leaps and bounds. It now holds 40% of the West Coast gasoline market, up from 25% two years ago...." (Emphasis added).

Also, the August 12, 1983 issue of The Lundberg Letter, page 5, (enclosed), provides:

> "First, few oil companies could embark upon such a bold course. Not all of them had an advantageous crude oil position (certainly not in Alaskan crude, and were possibly quite unable to set up a $3-a-barrel transfer price in suboptimizing refining and marketing costs)."

My clients believe that Arco is unlawfully utilizing its Alaskan crude position to the detriment of thousands of small businessmen and the United States Treasury. We are informed that the General Accounting Office, as well as the United States Treasury Department, have found substantial evidence that Arco's unlawful Alaskan crude practices have resulted in a substantial decline in its payment of windfall profit taxes, as well as subsidizing below-cost sales, which are designed to eliminate the competition of independent oil marketers.

If you have any questions, please do not hesitate to contact me.

Sincerely yours,

David Laufer

DAVID LAUFER

DL:dh:E
encs.

LAW OFFICES
SHAPIRO, LAUFER, KRANE, JACOBSON & POSELL
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

RICHARD H. CLOSE
LAWRENCE N. JACOBSON*
JULES L. KABAT*
SAMUEL KRANE*
DAVID LAUFER
RICHARD E. POSELL
KENNETH P. ROBERTS*
MITCHELL S. SHAPIRO
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JOHN C. GORMAN
MARK E. LEHMAN
JAMES H. LEHR
PAUL H. LEVINE
DENISE M. ROZELL
BEVERLY S. TILLETT
MARTIN A. WEISS

*A PROFESSIONAL CORPORATION

OF COUNSEL
B. D. FISCHER, INC.
MINDA R. SCHECHTER
RAYMOND WALLENSTEIN*

ONE CENTURY PLAZA, SUITE 2600
2029 CENTURY PARK EAST
LOS ANGELES, CALIFORNIA 90067
TELEPHONES
(213) 277-1818
(213) 879-9901

CABLE ADDRESS
"SHAPLAW"

TELEX NUMBER
66-4996

August 15, 1983

Mr. Robert Lawton
Deputy Director of Energy & Mineral Resources
United States Department of the Interior
Bureau of Land Management
18th and C Street, N. W.
Washington, D. C. 20240

Re: Submission of California Arco Distributors, Inc. and Agents Alliance, Inc.

Dear Mr. Lawton:

I am following up on the submission of my clients dated August 3, 1983 with material from the July 4, 1983 issue of Forbes, wherein it is stated:

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Sincerely yours,

David Laufer

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DL:dh:E
encs.